Supreme Court, U. S.
FILED
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MICHAEL RODAK, JR., CLERK

APPENDIX

IN THE

Supreme Court of the United States

October Term, 1978

No. 77-1724

HARRY G. BURKS, JR., *et al.*,

Petitioners,

v.

HOWARD M. LASKER, *et ano.*,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR CERTIORARI FILED JUNE 2, 1978
CERTIORARI GRANTED OCTOBER 2, 1978

INDEX

Relevant Docket Entries

United States District Court for the Southern District of New York

February 5, 1973—Filed complaint and issued summons.

November 12, 1973—Filed ORDER that the motion of defendants is hereby granted and ordered, that all further actions are stayed until twenty days following the trial or other determination of the claims asserted by Fundamental Investors, Inc. against Goldman, Sachs & Co. in the action entitled: *Welch Foods, Inc., et al.* v. *Goldman, Sachs & Co.*, 70 Civ. 4811 (the Welch action), or until further order of this Court; ordered that this order is granted without prejudice to an application by plaintiffs to vacate the same should it appear that the claims asserted by Fundamental Investors, Inc. against Goldman, Sachs & Co. in the Welch action are not being prosecuted with reasonable diligence.—Gurfein, Jr. (m/n)

February 3, 1975—Filed deft. Fundamental Investors, Inc.'s affdvt. and notice of motion to dismiss under Rule 12(b)—ret. 2-20-75.

September 26, 1975—Filed OPINION #43128 . . . that the motion under Rule 12(b) by THE FUND, joined by all defendants is denied without prejudice to renew the same upon the completion of discovery.—So ordered—Werker, J. m/n

October 14, 1975—Filed pltf's affdvt. and notice of motion for reargument of Court's opinion #43128—ret. 10-27-75.

January 7, 1976—Filed Order that plaintiffs' motion for reargument based on Judge Gagliardi's decision on *Boyko* v. *The Reserve Fund, Inc.*, is denied. Werker, J. m/n.

Docket Entries

July 30, 1976—Filed deft. Fundamental Investors affdt. of Roger Wickers in support of renewed motion to dismiss.

September 20, 1976—Filed deposition of Louis Frederick Laun dtd. 4-6-76.

September 20, 1976—Filed deposition of William J. Stephens dtd. 2-26-76.

September 20, 1976—Filed deposition of Mary S. O'Connor dtd. 3-9-76.

September 20, 1976—Filed deposition of John R. Haire dtd. 2-10-76.

September 20, 1976—Filed deposition of Beryl Robichaud dtd. 3-9-76.

September 20, 1976—Filed deposition of Leon T. Kendall dtd. 2-26-76.

September 20, 1976—Filed continued deposition of Leon T. Kendall dtd. 3-24-76.

September 20, 1976—Filed plaintiffs' deposition exhibits (re depositions of Haire, Kendall, O'Connor, Stephens, Robichaud and Laun).

January 12, 1977—Filed Opinion #45516 . . . Summary judgment is granted to the defendants—Werker, J. m/n.

January 17, 1977—Filed Judgment and Order that defendants have judgment against the plaintiffs dismissing the complaint.—Clerk. m/n.

January 27, 1977—Filed pltfs notice of appeal to the USCA for the 2nd Circuit from final judgment dismissing action and from prior rulings that produced final judgment.—copies mailed.

Relevant Docket Entries

United States District Court of Appeals for the Second Circuit

August 31, 1977—Argument heard (By: Lumbard, Oakes, Meskill, C.J.J.)

January 11, 1978—Judgment reversed, Lumbard, C.JJ.

January 25, 1978—Filed petition for rehearing and rehearing en banc, appellee, pfs.

March 9, 1978—Filed order denying petition for rehearing.

March 9, 1978—Filed order denying petition for rehearing en banc.

June 2, 1978—Call from Supreme Court that petition was filed today.

October 6, 1978—Filed certified copy of order of Supreme Court that writ of certiorari is hereby granted [October 2, 1978].

OPINIONS OF THE DISTRICT COURT

AND

COURT OF APPEALS

First Opinion of the District Court

UNITED STATES DISTRICT COURT,
S. D. NEW YORK.
Sept. 24, 1975.

As Amended October 17, 1975.

HOWARD M. LASKER and IRVING GOLDBERG,

Plaintiffs,

v.

HARRY G. BURKS, JR., et al.,

Defendants.

No. 73 Civ. 552 (HFW.)

MEMORANDUM DECISION AND ORDER

WERKER, *District Judge.*

This is a shareholders' derivative action brought by two stockholders on behalf of Fundamental Investors, Inc. ("Fundamental" or the "Fund"), a registered investment company under the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.* The defendants are the Fund's investment adviser, Anchor Corporation ("Anchor"), a registered investment adviser under the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 *et seq.*, and several former and present members of the Board of Directors of the Fund. The dispute between the parties centers around the Fund's purchase, on Anchor's recommendation, of $20 million in commercial paper of the now bankrupt Penn Central Transportation Company. As described in detail below the com-

plaint charges that in connection with the purchase of the Penn Central paper the defendants violated various sections of the Investment Company Act, the Investment Advisors Act and the common law. The Fund, joined by all defendants, has now moved under Rule 12(b) of the Federal Rules of Civil Procedure to dismiss this action on the ground that the independent members of the Board of Directors of the Fund have unanimously determined that, in their business judgment, this action is contrary to the best interests of the shareholders of the Fund.

Background

The Fund made its purchases of Penn Central 270-day notes from Goldman, Sachs & Co., in lots of $5 million each on November 26, December 2, 4 and 8, 1969. Unfortunately for the Fund and other holders of Penn Central commercial paper, Penn Central, on June 21, 1970, filed a petition for reorganization under section 77 of the Bankruptcy Act with the result that the notes were not paid at maturity or at any time to date. Faced with the possibility of a substantial loss, the Fund and other plaintiffs instituted suit in the Southern District of New York on November 4, 1970 against Goldman, Sachs & Co., for rescission of their purchases of the Penn Central Notes. That action was entitled *Welch Foods, Inc.* v. *Goldman, Sachs & Co.*, D.C., 398 F.Supp. 1393 (the "*Welch*" action).

The instant derivative suit was filed on February 5, 1973. Jurisdiction was predicated on section 44 of the Investment Company Act of 1940 (15 U.S.C. § 80a-43), section 214 of the Investment Advisers Act of 1940 (15 U.S.C. § 80b-14) and pendent jurisdiction. The complaint alleges that in making the purchases of Penn Central commercial paper

the Fund and Anchor relied solely and exclusively on Goldman, Sachs & Co., and made no independent investigation of the financial condition of Penn Central or the quality of its commercial paper. By failing to make an independent investigation it is alleged that Anchor failed to meet its responsibility as the Fund's investment adviser and that the Fund's directors knew or should have known of, and acquiesced in, the failure of Anchor to meet its responsibilities and thus failed to meet their responsibilities as members of the Fund's Board of Directors. Had an independent investigation been made it is alleged that a number of material adverse facts concerning the financial condition of the Penn Central and the quality of its commercial paper would have been learned. As a result of their actions, or inactions, the defendants are charged with engaging in acts and practices constituting gross misconduct and a gross abuse of trust in respect of the Fund in violation of section 36 of the Investment Company Act. Anchor is also alleged to have violated section 206, the antifraud section of the Investment Advisors Act of 1940. Plaintiffs also claim that the defendants violated their common law fiduciary duty to the Fund and that Anchor, aided and abetted by the directors, breached its investment advisory contract with the Fund.

The complaint goes on to allege that from November 28, 1969 to June 21, 1970, the date Penn Central filed for reorganization, the financial condition of the Penn Central deteriorated. During this period it is alleged that Anchor and the Fund directors failed to commence a thorough and adequate investigation of, and keep under continuous review, the financial condition of Penn Central and the quality and safety of its commercial papers. It is also alleged that during this period the Fund's directors failed in their obli-

gations to make adequate attempts to resell the Penn Central commercial paper it held and that Anchor failed to advise the Fund of the advisability of selling the commercial paper. Plaintiffs again claim that these acts by the defendants violate section 36 of the Investment Company Act; that Anchor violated section 206 of the Investment Advisers Act; that all defendants breached their common law fiduciary duty; and that Anchor, aided and abetted, by the Fund's directors breached its investment advisory contract. Finally, the complaint alleges that the defendants violated section 13 (a)(3) of the Investment Company Act by allowing the Fund to hold more than 10% of the securities of any one issuer (Penn Central) in contravention of the Fund's registration statement filed pursuant to section 8(b) of the Investment Company Act.

Subsequent to the filing of this derivative action, all defendants moved to stay this action pending the resolution of the claims of Fundamental in the *Welch* action. The stay was granted by Judge Gurfein on November 12, 1973. Fundamental's claims against Goldman, Sachs & Co., in the *Welch* action were settled on July 9, 1974. The terms of the settlement provided that Goldman, Sachs & Co. would take back the Penn Central notes, pay Fundamental $5,250,000.00 in cash and assign to Fundamental a 73.-75% interest in the proceeds of the notes in the reorganization proceedings.

With the settlement of the *Welch* action, Fundamental had to determine what position to take in this suit. It is necessary to set forth in detail the actions taken by the Fund's Board of Directors since it forms the basis of the defendants' motion to dismiss.

Fundamental's Board of Directors met on July 24, 1974 to review the settlement of the *Welch* action and to decide

what position to take in this derivative action. Since five of the directors are defendants in this action and one is a director of Anchor, the Board determined that the remaining five directors who they considered disinterested would, acting as a quorum pursuant to the bylaws,[1] decide what position the Fund should take in this action. The five disinterested directors then decided to retain the Honorable Stanley H. Fuld, former Chief Judge of the New York Court of Appeals, to review the entire Penn Central matter and to report to the Board.

After reviewing the complaint in this derivative action, the proceedings in the *Welch* action, the files of Anchor and the Fund relating to the purchase of Penn Central paper and after interviewing officers and employees of the Fund and analyzing th facts and the law, Judge Fuld sent a memorandum to the disinterested directors on December 5, 1974 in which he stated his opinion that there was "no violation by Anchor or by the Fund directors of any provision of statute or of any common law or contractual obligation to the Fund, in connection with the acquisition and re-

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[1] Section 1 of Article Eight of the Certificate of Incorporation of Fundamental provides that:

> "The number of directors which shall constitute the whole board of directors shall be such as from time to time shall be fixed by or in the manner provided in the by-laws which shall also provide the number of directors which shall contsitute a quorum; provided, that in no case shall a quorum be less than one-third of the total number of directors nor less than two directors."

Section 4 of Article Six of the By-Laws of Fundamental provides that:

> "*Quorum:* Except as otherwise provided by law, the Certificate of Incorporation, or these By-Laws, at all meetings of the Board of Directors one-third of the directors then in office, but not less than three directors shall be necessary for the transaction of business."

tention of the Penn Central commercial paper." (Dec. 5, 1974 Memorandum at 2). Judge Fuld went on to discuss in detail each of the claims asserted in this suit. Finally, Judge Fuld defined and discussed three alternative courses of action which the disinterested directors might pursue, *i. e.*, (1) seek realignment so as to become a plaintiff for the purpose of exercising control over and prosecuting the action; (2) conclude that the action is sufficiently lacking in merit and move to have the suit dismissed; and (3) take a neutral position and permit the action to proceed for the Fund's benefit under the auspices of the present plaintiffs.

After the disinterested directors reviewed his report and submitted questions to him, Judge Fuld sent a supplemental memorandum to the disinterested directors on December 18, 1974. In his memorandum Judge Fuld discussed in more detail the possibility that the Board should move to dismiss this suit as not being in the best interests of the Fund and the possible scope of judicial review of such a decision.

The disinterested directors then met in a series of special meetings to consider Judge Fuld's memoranda. The directors met with Judge Fuld; John R. Haire, Chairman and Chief Executive of Anchor; Donald L. Kemmerer and Charles F. Phillips, unaffiliated directors of Fundamental; and Eugene Souther, litigation counsel to Fundamental in this action. Questions were posed by the directors to all of these in attendance concerning the merits of the derivative action and the alternatives open to the Fund's Board. The disinterested directors again met in private and decided to give additional consideration to the problem and convey any questions to the designated Chairman of the disinterested directors, Leon T. Kendall.

A second special meeting of the disinterested directors was held on January 6, 1975. Upon review of the alternatives available, the directors present unanimously determined [2] that the prosecution of this action was contrary to the best interests of the shareholders of Fundamental and that counsel should be directed to seek dismissal of the action. The factors considered by the directors in reaching their conclusion are summarized in the Kendall affidavit ¶ 22, and are as follows:

> "(a) Chief Judge Fuld's opinion that there is no merit to the action and little likelihood of its success;
>
> (b) The business interruption to Anchor, distraction of its personnel and the likely inability for it to attract and maintain personnel during pendency of the action necessarily would be harmful to the shareholders of Fundamental;
>
> (c) If the action were to proceed against Anchor with the acquiescence or under the control of Fundamental, the adversary relationship that would be created between Fundamental and Anchor and the attendant serious distraction of Anchor's personnel from their efforts on behalf of the shareholders of Fundamental would leave us no practical alternative but to re-remove Anchor as investment adviser and to seek to retain a new investment adviser; this would necessarily result in delay, uncertainty and an inevitable lapse in the management of Fundamental's affairs to the serious detriment of its shareholders;

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[2] One director, Mary S. O'Connor, was not present at the meeting. She had previously told Mr. Kendall what her decision was. That vote was reaffirmed by Mrs. O'Connor at a special meeting of the disinterested directors held on January 22, 1975. Even without her presence, four directors would constitute a quorum.

(d) Anchor had acted in good faith and in what it believed was in the best interests of Fundamental's shareholders in purchasing the Penn Central comercial paper;

(e) Anchor had acted reasonably and had followed procedures prudent at the time in light of the then generally held belief that commercial paper was equivalent to cash;

(f) A vast number of other institutional investors, including many major banks in New York City and throughout the country and certain major mutual funds, had also believed that Penn Central was a sound business enterprise and had purchased Penn Central commercial paper at the time, and many such investors still held that paper when Penn Central petitioned for reorganization;

(g) To take no position at all and thereby to allow two of the more than 90,000 shareholders to determine the course of this action would not be a decision at all, but an avoidance of our obligation to all the shareholders;

(h) Chief Judge Fuld's advice that an investment adviser is not a guarantor of the investments it makes and can only be charged for breaches of contract or of the standards applied by the pertinent statutes and regulations. Chief Judge Fuld had analysed the facts and law and had concluded that Anchor was not at fault and that there was little likelihood that Anchor would be held to have violated any statute or regulation or to have breached any agreement or duty;

(i) Given Chief Judge Fuld's opinion, if the action were to proceed, there could be unnecessary costs to the shareholders of Fundamental for legal fees, both for its own counsel and for the director defendants, who would be entitled to reimbursement of counsel fees if they were found to be liable to Fundamental; and

(j) Even if there were a recovery of the theoretical maximum amount of damages, the net result to the shareholders of Fundamental would be little more than a net recovery of 10 cents per share, or approximately 2% of Fundamental's net asset value. The remote chance of recovering that small amount was not worth the risk of the serious damage to Fundamental's shareholders which proceeding with this action might produce."

Discussion

The Fund now argues that the extensive consideration given to the alternatives available to the independent directors culminating in their decision to seek dismissal of this suit was a good faith exercise of business judgment which cannot be upset by the two shareholder plaintiffs who would force Fundamental to maintain this action. The plaintiffs, of course, dispute this position. After emphasizing, the merits of the claims they have asserted and criticizing the conclusions reached by Judge Fuld, plaintiffs make the following arguments in opposition to the defendants' motion to dismiss: (1) because of the broad regulatory legislation embodied in the Investment Company and Investment Advisers Act, the decision whether to prosecute violations of that Act is not a matter of "business judgment" to

be decided by directors of a regulated fund; (2) to seek dismissal of the action would be tantamount to an unlawful ratification of defendants' conduct; (3) if a majority of the board's directors are disqualified, the existence of a "disinterested" minority is irrelevant; (4) as a matter of law the minority directors are not "disinterested;" (5) the minority directors gave undue deference to Anchor in making their decisions; and (6) the motion is premature and defective under Rule 23.1. These arguments will now be considered.

At the outset, the obvious should be stated—a shareholder's derivative suit is an action brought on behalf of a corporation in which any recovery runs in favor of the corporation. Ordinarily, it is the corporation which would seek the right to enforce any cause of action it might have. Rule 23.1 of the Federal Rules of Civil Procedure requires that a complaining shareholder demand action from the board of directors before bringing suit.[3] The purpose of

[3] Rule 23.1 provides:
"In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs."

that "demand" rule "is to give the derivative corporation itself the opportunity to take over a suit which was brought on its behalf in the first place, and thus to allow the directors the chance to occupy their normal status as conductors of the corporation's affairs." *Brody v. Chemical Bank*, 517 F.2d 932 at 934 (2 Cir. 1957), citing *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 263 (1st Cir.), *cert. denied*, 414 U.S. 857, 94 S.Ct. 161, 38 L.Ed.2d 107 (1973).

No demand was made on the Fund's Board of Directors in this case because plaintiffs alleged (and it is not disputed) that the majority of the Fund's directors are defendants charged with wrong doing and as such a demand would be futile.[4] While no set formula has been developed for determining what facts must be plead in order to excuse a demand on the Board of Directors—*see generally*, 7A Wright & Miller Federal Practice & Procedure § 1831 (1972)—that issue is not presented in this case. Instead, this case presents the rather unique situation where a designated independent minority of a Board has taken unilateral action with respect to a suit brought on behalf of the corporation. The decision of the independent directors was made after the settlement of the *Welch* action which put an end to the stay in this suit. Plaintiffs argue that even if suit were instituted at the present time (*i.e.*, after settlement of the *Welch* action) no prior demand on the Fund's Board would have been necessary because the majority of directors would be disqualified. To allow a minority of the Board to seek dismissal of the suit would, it is argued, destroy the role of "presumptive disqualification."

[4] No issue has been raised concerning whether a demand on the shareholders was necessary. Plaintiffs' complaint alleges that under applicable law and the Certificate of Incorporation and By-Laws of the Fund, the directors and officers are vested with the management of the Fund. Complaint ¶7(b).

While no case is directly in point, this circuit has recently considered an analogous issue in *Brody* v. *Chemical Bank*, *supra*. There, the district court had dismissed the derivative causes of action in plaintiff's complaint because the allegations in the complaint were insufficient to excuse a demand on the Board of Directors. Plaintiff had alleged futility of demand because the majority of directors were controlled by the defendant corporation. However, since institution of the suit, a new Board had been installed but no demand was made on it. The Second Circuit agreed that a demand should have been made but remanded because of the gravity of the alleged wrongdoing. 482 F.2d 1111 at 1114 (2 Cir.) After remand, the plaintiffs filed a second amended complaint but made no demand on the Board of Directors because they alleged that a demand on the Board of Directors at the time the action was originally commenced would have been futile. The district court again dismissed the derivative counts and the Second Circuit affirmed on the reasoning that a demand should have been made on the new directors. *Brody, supra* at 934.

In this case, within a short period after settlement of the *Welch* action and the dissolution of the stay, the Board of Directors met and designated the independent directors to make a decision as to the Fund's position in this suit. In the Court's view, the independent minority of directors had the power to decide what position the Fund should take. This is consistent with the policy that a corporation be given the opportunity to control a lawsuit brought on its behalf, that the Board be allowed to exercise its normal functions in running the corporation, and that a derivative suit should be resorted to as a last alternative. *See* 3B J. Moore, Federal Practice ¶ 23.1.19, at 23.1-252-53 (2d ed. 1974) quoted in *Brody, supra* at 934.

Although the independent directors could properly move for dismissal of this action it is now necessary to determine whether good faith business judgment of the directors can be used as a ground for dismissal. Defendants rely on a line of cases which hold that absent fraud or corruption or other disqualifying factor, the good faith business judgment of the directors not to bring suit is final. *See, e.g., Hawes v. Oakland*, 104 U.S. 450, 26 L.Ed. 827 (1881); *Corbus v. Alaska Treadwell Gold Mining Co.*, 187 U.S. 455, 23 S.Ct. 157, 47 L.Ed. 256 (1903); *United Copper Securities Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 37 S.Ct. 509, 61 L.Ed. 1119 (1917); *Swanson v. Traer*, 249 F.2d 854 (7th Cir. 1957); *Ash v. IBM*, 353 F.2d 491 (3d Cir. 1965), *cert. denied*, 384 U.S. 927, 86 S.Ct. 1446, 16 L.Ed.2d 531 (1966); *In re Kauffman Mutual Fund Actions*, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857, 94 S.Ct. 161, 38 L.Ed.2d 107 (1973). *Cf. Allegheny Corp. v. Kirby*, 344 F.2d 571 (2d Cir. 1965), *cert. dismissed*, 384 U.S. 28, 86 S.Ct. 1250, 16 L.Ed.2d 335 (1966).

As the Supreme Court recognized in *United Copper*, *supra*, the decision whether or not to sue is a matter of internal management. 244 U.S. at 263, 37 S.Ct. 509. Absent fraud or corruption or other factors, the stockholders cannot force the corporation to sue.

> "[Stockholders] cannot secure the aid of a court to correct what appear to them to be mistakes of judgment on the part of the officers . . . This rule applies whether the mistake is due to error of fact or of law, or merely to bad business judgment. It applies . . . where the mistake alleged is the refusal to assert a seemingly clear cause of action . . . ."

Ashwander v. Valley Authority, 297 U.S. 288, 343, 56 S.Ct. 466, 481, 80 L.Ed. 688 (1936).

The reasoning behind the "business judgment rule" and its application to derivative suits was recently discussed in this district in *Bernstein v. Mediobanca, Docket* #73 Civ. 3549, (S.D.N.Y. Dec. 24, 1974) (Connor, J.). There the Court reaffirmed the business judgment rule although summary judgment was denied, with leave to renew, because possible evidence of bad faith on the part of the Board of Directors in deciding not to sue was in the possession of the defendants and plaintiff was given an opportunity to discover it.

This court cannot accept plaintiffs' argument that because the allegations of the complaint concern violations of the Investment Company Act and the Investment Advisers Act, the Board has no power to exercise its business judgment because of the strong public policies behind those Acts. Unlike § 16(b) of the Securities Exchange Act which allows shareholders to bring suit if the directors decline a demand, Congress has made no such statutory provision with respect to suits brought under the Investment Company and Investment Advisers Act. It is true that causes of action under those Acts are implied rights of action. *Brown v. Bullock*, 194 F.Supp. 207 (S.D.N.Y., *aff'd* 204 F.2d 415 (2d Cir. 1961); *Bolger v. Laventhol, Krekstein, Horwath & Horwath*, 381 F.Supp. 260 (S.D.N.Y. 1974). It does not necessarily follow that because the right is implied a derivative suit should always be allowed despite the good faith exercise of business judgment by the directors not to sue. This court is of the opinion that absent a statutory exception, whether a cause of action is expressly authorized or is "implied" the directors of a corporation should be given the chance to perform their duties in running the business of the corporation including whether

to prosecute a cause of action. If they have exercised their business judgment in good faith then a decision not to sue should be final.

The court must also reject plaintiffs' argument that the decision not to sue was tantamount to an illegal ratification. Although it can be argued that derivative suits should be allowed when the Board has refused to sue on a non-ratifiable wrong—*see* Note, Demand on Directors and Shareholders as a Prerequisite To a Derivative Suit, 73 Harv.L.Rev. 746, 762 (1960); *Rogers v. American Can Co.*, 305 F.2d 297 (3d Cir. 1962), the question of business judgment is separate from the question of ratification. *S. Solomont & Sons Trust v. New England Theatres Operating Corp.*, 326 Mass. 99, 93 N.E.2d 241, 247 (1950). Many of the cases which established the business judgment rule and its relation to derivative suits have involved claims which were arguably non-ratifiable. *See, e. g., United Copper, supra; Ash v. IBM, supra* (antitrust violations).

Another question which has been considered is whether the merits of the plaintiffs' claim should be considered in deciding whether the directors decision should be upheld. To do so would place the Court in the position of substituting its judgment for that of the directors which if made in good faith should not be disturbed. The court has carefully reviewed the many factors which the Board considered before making its decision not to sue. Although plaintiffs argue that there is more merit to their claims than Judge Fuld gave them, there were many other factors considered by the directors, as outlined in the Kendall Affidavit ¶ 22—which led the directors to their decision.

If the minority directors were truly disinterested and independent the court will not substitute its judgment for

that of the Board. Plaintiffs have not argued that the minority directors have acted fraudulently or corruptly. They have argued that they are not disinterested or independent because they occupy similar positions with other funds in the Anchor group and that Anchor controls the selection and nomination of the Fund's directors. This assertion has been denied and it is alleged by the movant that these directors were nominated by a three man Directors Qualification Committee of which two members were unaffiliated with Anchor.

Interest or lack of independence would go toward the issue of good faith. I am constrained therefore to permit the plaintiffs to pursue discovery with respect to the relationships of the minority directors and the Qualifications Committee to determine whether the minority directors were disinterested or independent. It would appear that all of the other questions resolved herein are dependent upon a resolution of this issue. The plaintiffs are to conduct their discovery within 90 days from the date hereof.

The motion is denied without prejudice to renew the same upon the completion of discovery.

So ordered.

Unreported Opinion and Order of the District Court Denying Reargument

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

HOWARD M. LASKER AND IRVING GOLDBERG,

Plaintiffs,

against

HARRY G. BURKS, JR., EDWARD B. BURR, THOMAS F. CHALKER, JOHN R. HAIRE, HARVEY C. HOPKINS, S. P. HUTCHINSON, DONALD L. KEMMERER, A. S. MIKE MONRONEY, CHARLES F. PHILLIPS, JEPTHA WADE, ANCHOR CORP., and FUNDAMENTAL INVESTORS, INC.,

Defendants.

ORDER

HENRY F. WERKER, *D. J.*

Plaintiffs' motion for reargument based on Judge Gagliardi's decision in *Boyko* v. *The Reserve Fund, Inc.*, 74 Civ. 3419 (S.D.N.Y. Sept. 31, 1975) is denied. This court finds that *Boyko* is distinguishable from the case at hand due to the fact that *Boyko* concerns Section 36(b) of the Investment Company Act, 15 U.S.C. § 80a-35(b). That section specifically gives a security holder a cause of action against the investment adviser or an affiliated person on behalf of the investment company with respect to the receipt of compensation. The question of who should determine whether or not the corporation is to sue is different under Section 36(a), 15 U.S.C. § 80a-35(a), where the basis for suit is the more general claim of violation of fiduciary duty and where no cause of action is given in the statute to a security holder on such a claim.

So ordered.

Dated: New York, New York
January 6, 1976

HENRY F. WERKER
U.S.D.J.

Second Opinion of the District Court

UNITED STATES DISTRICT COURT,
S. D. NEW YORK.
Jan. 7, 1977.

HOWARD M. LASKER and IRVING GOLDBERG,
Plaintiffs,

v.

HARRY G. BURKS, JR., *et al.*,
Defendants.

No. 73 Civ. 552 (HFW).

OPINION

WERKER, District Judge.

This action, brought derivatively by two shareholders on behalf of Fundamental Investors, Inc. ("Fundamental" or the "Fund"), a registered investment company, seeks to recover damages resulting from the Fund's purchase of $20 million in 270-day notes issued by the now bankrupt Penn Central Transportation Company. The defendants are Anchor Corporation ("Anchor"), the registered investment adviser to the Fund, and several past and present members of the Fund's Board of Directors ("Board"). The defendants previously moved to dismiss this suit under Rule 12(b) of the Federal Rules of Civil Procedure because a voting quorum of disinterested directors found, in the ex-

ercise of its business judgment, that maintenance of the suit would not be in the best interests of the shareholders of the Fund. In a memorandum decision on that motion, 404 F. Supp. 1172, this court held that the business judgment rule [1] applied to the actions of the Fund and that it enabled the minority directors of the Board to seek dismissal of this suit provided only that they were "truly disinterested and independent." However, the court permitted the plaintiffs to conduct discovery for a designated period of time to determine whether the minority directors were in fact disinterested or independent, and the motion to dismiss was denied without prejudice to renew at the close of discovery. In accordance with that decision, the defendants have now renewed their motion to dismiss the instant action. The plaintiffs continue to argue that the motion should be deniel because, for various reasons, the minority directors did not, and could not, exercise their independent business judgment in moving to terminate this action.

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[1] Under the rule,

"'. . . Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to their honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient.' *Politz* v. *Wabash R. Co.*, 207 N.Y. 113, 124, 100 N.E. 721, 724. Indeed, although the concept of 'responsibility' is firmly fixed in the law, it is only in a most unusual and extraordinary case that directors are held liable for negligence in the absence of fraud, or improper motive, or personal interest." *Bayer* v. *Beran*, 49 N.Y.S.2d 2, 6 (Sup. Ct. 1944).

I

The facts surrounding this action have been described at length in my earlier memorandum decision; nevertheless, some repetition of that discussion will facilitate an understanding of the court's action upon the present motion by the defendants.

The complaint alleges, among other things, that Anchor breached its statutory, contractual and common law fiduciary duties by relying exclusively upon the representations of *Goldman, Sachs & Co.* (a seller of commercial paper), rather than independently investigating the quality and safety of the Penn Central 270-day notes purchased by the Fund. It is further alleged that the defendant directors knew or should have known of Anchor's failure to meet its responsibility; that they violated their common law duties as corporate fiduciaries by acquiescing in Anchor's omissions; that the financial condition of the Penn Central steadily worsened during the period from November 28, 1969 to June 21, 1970, the date that it filed for reorganization; and that during this period of decline all of the defendants failed to investigate and review the financial condition of the Penn Central and the quality and safety of its commercial paper. It is also alleged that during this period Anchor failed to recommend, and the defendant directors failed to attempt, sale of the Penn Central paper held by the Fund.

Prior to the institution of this action, the Fund and other plaintiffs brought suit against *Goldman, Sachs* seeking rescission of their purchases. *See Welch Foods, Inc. v. Goldman, Sachs & Co.*, 398 F.Supp. 1393 (S.D.N.Y. 1974) (the "*Welch*" action). On the motion of all defendants to this action, Judge Gurfein, then a district court judge, granted

a stay of further proceedings in this action pending resolution of the Fund's claims in *Welch*. Thereafter, on July 9, 1974 the Fund agreed to settle its claims against *Goldman, Sachs*. Under the terms of the settlement agreement, *Goldman, Sachs* was to take back the notes and the Fund was to receive $5,250,000 in cash and a 73.75 percent interest in any proceeds of the notes obtained during the course of the Penn Central reorganization proceeding.

With the claims of Fundamental in the *Welch* matter resolved, the Board once again faced the question of what to do in the instant action. Briefly, the Board determined that five of its members were dininterested (the "disinterested quorum" or "minority directors") and therefore able to determine the proper course of action for the Fund.[2] The disinterested quorum then retained the Honorable Stanley H. Fuld, former Chief Judge of the New York Court of Appeals, to review the circumstances surrounding the purchase and retention of the Penn Central notes and prepare an opinion for its consideration. In a memorandum to the disinterested quorum dated December 5, 1974, Judge Fuld concluded that neither Anchor nor the defendant directors of the Fund had violated the law "in connection with the acquisition or retention of the Penn Central commercial paper." Judge Fuld's memorandum discussed several positions that the disinterested quorum could take on behalf of the Fund, one of which was concluding that the suit lacked merit and moving to dismiss. The minority directors met with Judge Fuld at a special meeting of the disinterested quorum held on December 18, 1974 and requested that he submit a further memorandum before they took any action.

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[2] Under Article Eight of the Certificate of Incorporation of Fundamental, a quorum of the Board may not be less than one-third of the total number of directors. Since the full Board consisted of ten members, there was no problem here.

The minority directors also questioned several of the defendants before deciding at a second special meeting of the disinterested quorum, held on January 6, 1975, to seek dismissal of the instant action.[3] An affidavit submitted by the chairman of the disinterested quorum as part of the earlier motion to dismiss recounts ten factors that the disinterested quorum considered in arriving at its decision. The relevant portion of that affidavit appears in my earlier decision, 404 F.Supp. at 1176-77.

II

On the defendants' initial motion to dismiss, this court considered and rejected the contention of the plaintiffs that the merits of their derivative claim should color the court's consideration of the business judgment "defense." The court also reviewed the claim of the plaintiffs that the strong public policy behind the Investment Company Act of 1940, 15 U.S.C. § 80a-1, *et seq.*, and the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1, *et seq.*, precluded application of the business judgment rule to the actions of mutual funds. The court observed that

> "absent a statutory exception whether a cause of action is expressly authorized or is 'implied' the directors of a corporation should be given the chance to perform their duties in running the business of the corporation, including whether to prosecute a cause of action. 404 F.Supp. at 1180.

Both of these contentions have been reasserted in substantially unchanged form in the plaintiffs' papers in opposition to the renewed motion to dismiss. While a certain degree of tenacity is the mark of accomplished counsel, what the plaintiffs now seek is an opportunity to reargue the court's prior decision after the time to do so has passed. To accede to that request would require the court to reconsider arguments previously rejected without having been shown that there is a need to do so. Consequently, the court will only consider the question it did not reach before: whether the minority directors were disinterested and independent.

[3] As was noted in my earlier decision in this matter, although one of the five minority directors voted by proxy, even without her vote, the presence of four directors at the meeting constituted a quorum.

Since the parties have each submitted affidavits and excerpts from the extensive deposition testimony to assist in the disposition of the instant motion, the court must treat the motion as one for summary judgment under Rule 56 of the Federal Rules of Civil Procedure. Rule 12(b), Fed. R.Civ.P.

III

The plaintiffs first contend that the structure of the mutual fund industry, which subjects mutual funds to extensive control by their investment advisers, precludes a finding of independence in this instance.[4] Specifically, they

[4] In this regard, plaintiffs note Chief Judge Kaufman's recent statement that:

> "The relationship between investment advisers and mutual funds is fraught with potential conflicts of interest. The typical fund ordinarily is only a shell, organized and controlled by a separately owned investment company adviser, which selects its portfolio and administers its daily business. Compensation for these services is determined under an advisory contract, the terms of which are all too often dictated to unwary or negligent fund directors and fund shareholders by the investment adviser." *Galfand* v. *Chestnutt Corp.*, Civ. No. 76-7156 (S.D.N.Y. Nov. 4, 1976).

maintain that the large number of shareholders in the Fund coupled with the small size of each shareholder's interest, makes proxy contests impossible to wage and ensures that the Board will only contain directors amenable to the policies of the Fund's management.[5] The plaintiffs also suggest that the service of each minority director for compensation on the boards of other "Anchor" funds demonstrates their inability to act independently. In this vein, the plaintiffs maintain that business and personal relationships among the defendants and minority directors make it impossible to conclude that the disinterested quorum acted independently; that even if the minority directors acted in good faith, their loyalties must have been divided.

Plaintiffs have not adduced any factual support for their conclusion that the members of the disinterested quorum acted other than independently. Although each of the minority directors knew someone on the Board at the time that he or she was nominated, the relationships which existed between the minority directors and the defendant directors were *de minimis,* even as they are stated by the plaintiffs, and do not suggest that the business judgment rule should not be applied.

There is also no reason to conclude that the business judgment rule is inapplicable merely because each minority director receives remuneration for service on the boards of other "Anchor" funds. Most corporate directors receive some compensation for their services, but absent a showing of improper motive they have always been per-

[5] At about the time that the minority directors determined to seek the dismissal of this action, there were approximately 141,000 shareholders in the Fund. No shareholder had a beneficial interest greater than one percent.

mitted to apply their business judgment to decisions involving derivative suits brought against the corporations they serve. *See e.g., Warshaw* v. *Calhoun,* 43 Del.Ch. 148, 221 A.2d 487 (Sup.Ct.1966). I am not persuaded that there is any meaningful distinction between remuneration by one corporation rather than several corporations similar in structure. This is not, after all, an instance where it is alleged that a minority director received payments from the investment adviser or other persons whose interests conflict with those of the Fund.

The plaintiffs' contention that a minority director of a mutual fund can never act independently given the relationship between mutual funds and their advisers parallels, to some extent, their previously rejected argument that the business judgment rule should not apply to mutual funds registered under the Investment Company Act of 1940. In making this claim, plaintiffs apparently rely upon *Fogel* v. *Chestnutt,* 533 F.2d 731 (2d Cir. 1975), *cert. denied,* 429 U.S. 824, 97 S.Ct. 77, 50 L.Ed.2d 86 (1976), but that decision is inapposite. In the *Fogel* case, two mutual fund stockholders brought a derivative suit on behalf of a mutual fund against several affiliated fund directors and the advisor to the fund. The plaintiffs sought to recapture a portion of the brokerage commissions paid on fund transactions on the theory that the affiliated directors had "intentionally misled and misinformed the [f]und's unaffiliated directors by telling them that such recapture was not available to the [f]und." *Id.* at 737.

Writing for the *Fogel* panel, Judge Friendly observed that:

> "Congress had mandated independent directors in order 'to supply an independent check on manage-

ment and to provide a means for the representation of shareholder interests in investment company affairs.' [citation omitted]. The minimum requirement to enable the [f]und's independent directors to discharge these duties with respect to recapture was a careful investigation of the possibilities performed with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons. It would have been still better to have the investigation of recapture methods and their legal consequences performed by disinterested counsel furnished to the independent directors."

Id. at 749-50.

Significantly, Judge Friendly went on to observe that:

> "If this had been done and the independent directors had concluded that, because of legal doubts, business considerations or both, the [f]und should make no effort at recapture, we would have a different case."

Id. at 750.

In the instant action, the minority directors were furnished with disinterested counsel who analyzed the lgal consequences of each alternative available to the disinterested quorum. Moreover, the affidavit of the quorum chairman and the minutes of the special meetings indicate that the minority directors acted only after they had fully considered the options available to them. Clearly, then, under *Fogel* it was proper for them to determine what the Fund's posture would be.

IV

The plaintiffs next contend that the lack of true independence and disinterestedness on the part of the minority directors is apparent from the manner in which they decided to seek dismissal in the instant action. In support of this claim, plaintiffs point to the actions of Roger T. Wickers, an Anchor vice-president who formerly served as the secretary to the Fund, and Eugene P. Souther, who was retained as special counsel to the Fund for the purposes of this litigation, as well as to the circumstances surrounding the meetings of the minority directors.

At the direction of defendant Haire, Wickers explored the possibility of retaining special counsel for the disinterested quorum. After contacting several distinguished attorneys, Wickers reported that Judge Fuld would be available to serve the minority directors and, at a Board meeting held on July 24, 1974, it was Wickers who proposed that a disinterested quorum act for the Fund in the instant action. Wickers also coordinated the arrangements for Judge Fuld's investigation for the minority directors, who were residents of several different states.

The plaintiffs maintain that "the inappropriateness of Wickers role as intermediary is manifest," but I disagree. The plaintiffs have not set forth any facts in support of their suggestion that Wickers improperly influenced the deliberations of the disinterested quorum. Instead they have engaged in totally unsubstantiated supposition. For example, plaintiffs contend that Wickers retained Judge Fuld, but the sworn affidavit of Wickers and the deposition of at least one minority director establish that Judge Fuld was retained by the minority directors to act upon instructions communicated to him at the direction of the disin-

terested quorum.[6] In the absence of some factual support for the plaintiffs' allegations, the court cannot conclude that it was improper for Wickers to coordinate the administrative details of Judge Fuld's inquiry or that Wickers' actions reduced the independence of the minority directors.

It is the court's opinion that the role of Souther was equally innocent. The plaintiffs advance two reasons why it was inappropriate for him to participate as he did in the deliberations of the disinterested quorum. First, they note that he was an "interested person" within the meaning of § 2 of the Investment Company Act, 15 U.S.C. § 80a-2(a)(19)(A)(iv)[7] because his law firm had acted as legal counsel to the Fund during the last two fiscal years. They question whether the minority directors could arrive at a disinterested decision when they were advised by an attorney who was "interested." Second, the plaintiffs contend that it was improper for his firm to counsel parties with divergent interests, namely the Fund and the disinterested quorum.

All attorneys providing legal counsel to mutual funds become, by definition, "interested persons" for some period

[6] Even if Wickers did retain Judge Fuld for the minority directors, I see nothing improper in that. In fact, in *Fogel, supra,* Judge Friendly suggested that it was desirable for disinterested counsel to be *"furnished"* to the independent directors.

[7] Under the statute:

"(19) 'Interested person' of another person means—
(A) when used with respect to an investment company—

* * * * *

(iv) any person or partner or employee of any person who at any time since the beginning of the last two fiscal years of such company has acted as legal counsel for such company . . ."

of time. Under § 10 of the Investment Company Act, 15 U.S.C. §80a-10, only 60 percent of the members of the board of a registered company may be interested persons. Designating Souther as an interested person, therefore, only serves to limit his participation on the Board as a *director*. It does not mean that the minority directors were interested in the suit, that their deliberations were somehow subject to improper influence or that they lacked the necessary degree of independence.

Plaintiffs nevertheless suggest that in accordance with Judge Frankel's recent decision in *Papilsky v. Berndt*, CCH Fed.Sec.L. Rep. ¶ 95,027 (S.D.N.Y. 1976), it was improper for Souther to advise both the Fund and the minority directors. However, in *Papilsky* the law firm advising the fund also served as the investment adviser's counsel, and, as Judge Frankel noted, there was no "suggestion to the Board that, because of the possible conflict of interest, the independent directors should seek disinterested counsel." *Id.* at 90, 133. In the instant action, independent legal advice for the minority directors was not only recommended, it was also obtained. Moreover, there was no conflict of interest on the part of Souther or his law firm: they were retained to represent the Fund in the instant action and it was the disinterested quorum, acting for the Fund, which gave them their instructions as to how to proceed.

The plaintiffs also contend that the presence of several defendants during the initial presentations of Judge Fuld and Souther at the first special meeting of the disinterested quorum demonstrates the minority directors' lack of independence. But the minutes of that meeting and the deposition testimony show that the minority directors invited those defendants to join the meeting so that they could

answer questions raised by the minority directors. The minutes of the meeting also indicate that all of the defendants and counsel were excused before the disinterested quorum determined in executive session that it wished to review the pertinent documents and formulate further questions to be answered before reaching any decision.

In this context plaintiffs point to the allegedly misleading nature of statements made to the minority directors by defendant Haire. The minutes of the first special meeting of the disinterested quorum state that Haire "questioned the ability of Anchor to attract and retain the highly qualified personnel they want and need if [the instant action] were being pursued with the acquiescence, if not under the control, of the Fund." The plaintiffs consider this to be in sharp disagreement with Haire's testimony at his disposition that he "never at any time had any doubt that [Anchor] could continue to effectively serve the [F]und if . . . requested to continue or permitted to continue by the board or the shareholders." Apparently to underscore the materiality of Haire's discouraging words to the minority directors, plaintiffs note the contents of an affidavit by the chairman of the disinterested quorum. In that affidavit, the quorum chairman states that in reaching their decision the directors considered that:

> "(c) If the action were to proceed against Anchor with the acquiescence or under the control of Fundamental, the adversary relationship that would be created between Fundamental and Anchor and the attendant serious distraction of Anchor's personnel from their efforts on behalf of the shareholders of Fundamental would leave us no practical alternative but to remove Anchor as investment advisor and to seek to retain a new investment advisor; this would

> necessarily result in delay, uncertainty and an inevitable lapse in the management of Fundamental's affairs to the serious detriment of its shareholders . . ."

The court is of the opinion that Haire's statements are neither inconsistent nor misleading. His assertions only indicate that he believed it would have been difficult, but not impossible, for Anchor to have continued its service to the Fund faced with this lawsuit. The affidavit of the disinterested quorum chairman shows only that the minority directors reached a different conclusion: that prosecution of the suit "would necessarily cause the Fund to seek to obtain a different investment adviser immediately." Even if the minority directors erred in this determination, as I have noted in my previous decision, the court cannot upset their reasoned judgment without some showing that the independence of the disinterested quorum was impermissibly curtailed. The plaintiffs have not presented any such evidence.

V

Finally, the plaintiffs contend that under *Perlman v. Feldman,* 219 F.2d 173, 178 (2d Cir.), *cert. denied,* 349 U.S. 952, 75 S.Ct. 880, 99 L.Ed. 1277 (1955), and *Pepper v. Litton,* 308 U.S. 295, 306, 60 S.Ct. 238, 84 L.Ed. 281 (1939), the defendant directors bear the burden of proving by clear and convincing evidence that they did not breach their fiduciary responsibilities to the corporation and its stockholders. The defendants argue that the plaintiff must shoulder the evidentiary burden because it is the exercise of business judgment by corporate directors which is chal-

lenged. *Bellis v. Thal,* 373 F.Supp. 120, 124 (E.D.Pa.1974), *aff'd,* 510 F.2d 969 (3d Cir. 1975); *Marco v. Bank of New York,* 272 F.Supp. 636, 639 (S.D.N.Y. 1967), *aff'd,* 398 F.2d 628 (2d Cir. 1968); *Warshaw v. Calhoun, supra.*

The *Perlman* and *Pepper* cases relied upon by the plaintiffs both involve self-dealing by corporate fiduciaries and are inapplicable here. As I noted in my earlier decision in this matter, the plaintiffs "have not argued that the minority directors have acted fraudulently or corruptly." 404 F.Supp. at 1180. Moreover, the question before the court is not whether *the defendants* breached their fiduciary obligations to the corporation, but whether suit can proceed against them at all given the decision of the nondefendant minority directors to seek dismissal of this action.

It is therefore incumbent upon the plaintiffs to establish that the minority directors actions lacked independence. *Marco v. Bank of New York, supra.* The unsupported contentions of the plaintiffs clearly fail to meet this burden and, accordingly, it is the opinion of this court that the defendants, both corporate and individual, cannot be required to proceed to a trial. I hasten to add, however, that even if the defendants are required as a matter of law to negate any suggestion of unfairness arising from the decision to abandon the derivative claims raised in this suit they have done so. The exhibits presented to the court on both the earlier motion to dismiss and the instant motion show that the minority directors carefully evaluated the opinions tendered by both counsel involved in this action, that they considered the merits of the derivative claims asserted in the complaint, that they discussed the facts and circumstances surrounding the purchase and retention of the notes with several of the defendant directors and that

they communicated extensively among themselves before reaching a decision to seek dismissal of this suit.

To conclude that the disinterested quorum acted in response to pressure and without justification to immunize Anchor and the defendant directors from possible liability would require this court to presume that bias exists based upon circumstances which seem entirely innocent. For example, as has been noted, the plaintiffs suggest that a finding of improper influence must follow from the fact that the minority directors each knew someone on the Board when they were first selected for nomination or election to the Board. But the existence of casual relationships among the directors, without more, cannot be taken as an indication that the minority directors were unable to reach an independent business decision. Similarly, because the Investment Company Act terms an attorney whose advice is sought to be an "interested person," plaintiffs seek to suggest that the minority directors had an interest in the contested transaction which went beyond a generalized concern for the security of the Fund.[8] But here again it was obviously reasonable for the minority directors to consult with interested persons, rather than reaching a decision without speaking to either the directors involved in the transaction or counsel.

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[8] In a similar effort to brand a minority director as interested, plaintiffs point to the following testimony by director Stephens:

> "I remember commenting [at the July 24, 1974 board meeting] on what constituted a disinterested director because in my opinion no director could be disinterested, but I was told that was the proper term.

Later Stephens explained that he didn't like the term "disinterested" since he certainly was not "uninterested."

Second Opinion of the District Court

The court of appeals for this circuit has recently cautioned that summary judgment may not be granted unless, drawing all *reasonable* inferences in favor of the nonmovant, no material factual issue is shown. *Heyman* v. *Commerce and Industry Insurance Co.*, 524 F.2d 1317 (2d Cir. 1975). However, the party opposing the motion must adduce something beyond conclusory allegations. *Donnelly v. Guion*, 467 F.2d 290 (2d Cir. 1972). Here, there has been no showing by the plaintiffs of facts which, if proven, would prohibit the defendants from hiding behind the business judgment cloak. Accordingly, the defendants are granted summary judgment.

SO ORDERED.

Opinion of the Court of Appeals

No. 23, Docket 77-7060.

UNITED STATES COURT OF APPEALS,
SECOND CIRCUIT.

Argued Aug. 31, 1977.
Decided Jan. 11, 1978.

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HOWARD M. LASKER and IRVING GOLDBERG,

Plaintiffs-Appellants,

v.

HARRY G. BURKS, JR., EDWARD B. BURR, THOMAS F. CHALKER, JOHN R. HAIRE, HARVEY C. HOPKINS, S. P. HUTCHISON, DONALD L. KEMMERER, A. S. MIKE MONRONEY, CHARLES F. PHILLIPS, JEPTHA H. WADE, ANCHOR CORPORATION AND FUNDAMENTAL INVESTORS, INC.,

Defendants-Appellees.

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LUMBARD, Circuit Judge:

This appeal by two mutual fund shareholders raises an important question of first impression: can minority directors of a registered mutual fund, who were nominated by the majority directors of the fund to be "independent" directors pursuant to the requirements of the Investment Company Act, 15 U.S.C. § 80a-10(a), terminate a non-frivolous stockholder's derivative action against the fund's majority directors and its investment adviser? We are of the view that to permit such action by those "independent"

minority directors of a registered mutual fund would be contrary to the public interests which Congress has sought to protect. Accordingly, we reverse the judgment of the district court which dismissed the complaint and remand for further proceedings.

Howard Lasker and Irving Goldberg commenced this derivative action in February, 1973, against individuals who had been directors of Fundamental Investors, Inc. (the Fund), an open-end investment company [1] registered under the Investment Company Act, 15 U.S.C. § 80a-1 to -52, and the Fund's registered investment adviser, Anchor Corporation. The plaintiffs sought to recover losses sustained by the Fund in connection with its purchase between November 28 and December 8, 1969, of $20 million in Penn Central 270-day notes from Goldman, Sachs & Co. The derivative complaint charged the defendants with violations of §§ 13(a)(3) and 36 of the Investment Company Act, 15 U.S.C. §§ 80a-13(a)(3), 80a-35 (1970), breach of their common-law fiduciary duties, violations of § 206 of the Investment Advisers Act, 15 U.S.C. § 80b-6 (1970), and breach of Anchor's investment advisory contract with the Fund.

It is undisputed that Anchor never made any independent investigation of Penn Central's financial situation before the Fund's purchase of the notes. Moreover, although reports of Penn Central's operations in early 1970 showed mounting losses, it was not until May that the Fund officers made any attempt to resell any part of the notes to Goldman, Sachs, or otherwise to realize on the investment. On June 21, 1970, Penn Central filed a petition for reorganization which is still in process in the Eastern District of Pennsylvania. Consequently, the Fund's Penn Central notes were not paid at maturity.

[1] An open-end investment company is defined in § 5(a)(1) of the Investment Company Act, 15 U.S.C. § 80a-5(a)(1) (1970), as an investment company that offers "for sale or has outstanding any redeemable securities of which it is the issuer." "Investment company" is defined in § 3(a) of the Act, 15 U.S.C. § 80a-3(a) (1970).

In November 1970, the Fund, joined by three other noteholders,[2] sued Goldman, Sachs in the Southern District of New York for recovery of their losses arising from their purchases of Penn Central notes. In July 1973, then District Judge Gurfein stayed the instant action, which had been commenced five months earlier, pending resolution of the suit against Goldman, Sachs. That suit was settled on behalf of the Fund in July 1974. Under the settlement, Goldman, Sachs took back the Fund's Penn Central notes, paid the Fund $5,250,000, and assigned to the Fund a 73.75 percent interest in the proceeds of the notes in the reorganization proceedings. The Fund's co-plaintiffs did not settle, and the jury rendered verdicts in their favor against Goldman, Sachs for the full amount of their claims.[3]

On July 24, 1974, the Fund's board of directors met and discussed the pending *Lasker* case. They decided that five of the statutorily disinterested directors, none of whom were involved in the derivative action,[4] should decide what action should be taken regarding the *Lasker* case, and act

[2] In addition to the Fund, Welch Foods, Inc., C. R. Anthony Company, and Younker Brothers, Inc. sued Goldman, Sachs in a single action. See *Welch Foods Inc. v. Goldman, Sachs & Co.*, 398 F.Suppp. 1393 (S.D.N.Y. 1974).

[3] See *Welch Foods Inc. v. Goldman, Sachs & Co.*, 398 F.Supp. 1393 (jury verdict S.D.N.Y. 1974).

[4] Of the remaining six directors of the eleven member board, all were defendants to the *Lasker* action and/or affiliated with Anchor.

accordingly on behalf of the entire board.[5] This procedure had been discussed prior to the July board meeting by the defendant John R. Haire, president of the Fund and chairman of Anchor's board of directors, and Roger Wickers, an officer of both the Fund and Anchor. Upon Haire's instruction, Wickers had ascertained that Stanley H. Fuld, former chief judge of the New York Court of Appeals, would be available to serve as special counsel. The minority directors agreed to consider what should be done about the *Lasker* case, and instructed Wickers to retain Judge Fuld to advise them.

Judge Fuld, in his report of December 5, 1974, supplemented on December 18, 1974, concluded, on the basis of the information furnished to him, that neither Anchor nor the Fund directors would be found liable under federal or state law. At the same time, Judge Fuld pointed out the absence of legal authority on whether a mutual fund's investment adviser is required to conduct independent research regarding its investment recommendations. He further cautioned that it was "impossible to predict . . . what a trier of fact will find, particularly in complex circumstances." After considering the special counsel's reports, on January 6, 1975, the minority directors instructed counsel for the Fund to seek dismissal of the *Lasker* action on the ground that it was their business judgment that further prosecution of the action would not be in the best interests of the Fund.

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[5] Under the Fund's bylaws and Delaware corporate law, five of the Fund's twelve member board of directors constituted a quorum of the entire board. Del.Code tit. 8, § 141 (1975); Fundamental Investors, Inc., Certificate of Incorporation, Article EIGHTH; Fundamental Investors, Inc., Bylaws section 4, Article VI.

The five directors appointed to review the *Lasker* action were: Leon Kendall, elected to the board in June 1974; Beryl Robichaud, elected in September 1973; William Stephens, elected in September 1973; Mary O'Connor, elected in June 1972; and Louis Laun, who became a director in the fall of 1971.

Judge Werker, in passing on the motion to dismiss, held that the minority directors, in the exercise of their business judgment, had the power to bar further prosecution of the case, provided they were truly disinterested and independent. As a factual issue had been raised regarding whether the minority directors were independent and disinterested, he granted discovery on that issue. *Lasker* v. *Burks*, 404 F.Supp. 1172 (S.D.N.Y.1975). After such discovery, the motion to dismiss was renewed and granted by Judge Werker on January 7, 1977. In his second opinion, 426 F.Supp. 844 (S.D.N.Y.1977), Judge Werker found no factual support for the conclusion that the minority directors had not acted independently. In accordance with his earlier opinion, he dismissed the complaint.

From what this record discloses regarding the Fund's investment in Penn Central notes on Anchor's advice, we cannot say that, following a trial on the merits, the defendants would be found free from liability for the Fund's losses. We see nothing in the findings of Congress, the legislation regulating investment companies and their advisers, or in the decisions of the courts which suggests that under such circumstances disinterested directors, such as the five who acted here, have the power to terminate litigation brought by mutual fund stockholders against the fund's investment adviser and its majority directors for breach of their fiduciary duties. On the contrary, the findings of Congress, the statutory scheme, and the relevant case law persuade us that the statutorily disinterested directors of a registered investment company were never meant to have the final word in determining whether it is in the best interest of a mutual fund to press claims against their co-directors, and the adviser with which those directors are affiliated, for breach of fiduciary duties.

In response to disclosure of grave abuses in the management of investment companies, Congress in 1940 enacted the Investment Company Act (ICA), 15 U.S.C. §§ 80a-1 to -52 (1970), and the Investment Advisers Act (IAA), 15 U.S.C. §§ 80b-1 to -21 (1970). Congress acted after receiving a report from the Securities and Exchange Commission which showed that investment funds were organized by investment advisers; that the funds were administered under contracts that where highly favorable to the advisers; that the directors of the funds were selected by the investment adviser; and that the board was usually dominated by persons affiliated with the adviser.[6] Congress found that numerous practices in the management of such funds adversely affected the national public interest and the interest of investors. Accordingly, Congress declared it to be the policy and purpose of the ICA to mitigate and eliminate those aspects of the conduct and administration of the funds which benefitted the managers and adversely affected the stockholders of the fund.[7]

The ICA provides that no more than 60% of a registered company's board of directors can be "interested persons" affiliated with the investment adviser.[8] Moreover, it gives the statutorily disinterested directors, usually referred to as "independent directors," certain powers to supervise management and auditing arrangements.[9] Thus,

[6] See SEC, Report on the Study of Investment Trusts and Investment Companies, pt. 3, 1-49, 1922 (1940). See also Comment, Duties of the Independent Directors in Open-End Mutual Funds, 70 Mich.L.Rev. 696, 701 (1972).

[7] See 15 U.S.C. § 80a-1 (1970).

[8] See 15 U.S.C. §§ 80a-10, 80a-2(a)(3), (19) (1970).

[9] See generally Comment, Duties of the Independent Director in Open-End Mutual Funds, 70 Mich.L.Rev. 696 (1972).

section 15(c) of the ICA, 15 U.S.C. § 80a-15(c) (1970), imposes on the disinterested directors the duty to review and approve the contracts of the investment adviser and the principal underwriter; section 16(b), 15 U.S.C. § 80a-16(b) (1970), provides that the statutorily disinterested directors will appoint other disinterested directors to fill vacancies resulting from the assignment of the advisory contracts; and section 32(a), 15 U.S.C. § 80a-31(a) (1970), requires that the accountants who prepare the investment company's Securities and Exchange Commission financial filings be selected by the statutorily disinterested directors. We conclude, therefore, that the statutes were designed to interpose statutorily disinterested directors as a check on the actions of the majority directors controlled by the investment adviser. It would be contrary to the legislative purpose to permit the independent minority to be used to approve majority action so that no stockholder complaint could survive that approval.

Congress has not been satisfied, moreover, that the presence of disinterested directors who observe their duties will be sufficient protection to the stockholders, as it has specifically provided in section 36(b) that shareholders may sue derivatively to recover excessive fees to the adviser and the prinicpal underwriter. See 15 U.S.C. § 80a-35(b) (1970). Section 36(b) was enacted as a part of the 1970 amendments, which resulted in part from the Senate report which indicates that the mere presence of disinterested directors on the boards of mutual funds was not sufficient to protect funds against overreaching investment advisers.[10]

[10] See 1970 U.S.Code Cong. & Admin.News, pp. 4897, 4901. In 1970 both the ICA and the IAA were substantially amended. See Act of December 14, 1970, Pub.L. No. 91-547, 84 Stat. 1413.

We have been sensitive to the need for protection of the public interest in accordance with the views of Congress. Thus, in *Galfand* v. *Chestnutt,* 545 F.2d 807 (2d Cir. 1976), we found that the investment adviser had abused its position of trust by securing a favorable modification of its advisory contract without fully disclosing to the fund's directors the ramifications of the changes. Writing for the panel, Chief Judge Kaufman observed that, "[t]he relationship between investment advisers and mutual funds is fraught with potential conflicts of interest. The typical fund ordinarily is only a shell, organized and controlled by a separately owned investment company adviser, which selects its portfolio and administers its daily business." Id. at 808. See also *Tannenbaum* v. *Zeller,* 552 F.2d 402 (2d Cir. 1977).

Moreover, in many instances where no specific authority is granted by statute the courts have inferred that stockholders may bring suit. See, e.g., *Abrahamson* v. *Fleschner,* 568 F.2d 862 at 873 (2d Cir. Feb. 25, 1977) and cases cited therein. It would surely be anomalous to hold that the statutorily disinterested directors could determine not to pursue litigation against their co-directors for liability which may amount to many millions of dollars, and foreclose the stockholders from continuing such litigation, while at the same time stockholders by statute are empowered to recover excess fees paid the adviser and underwriter.

In the ordinary routine of running an investment trust, the disinterested directors must constantly deal with interested directors in a spirit of accommodation. Indeed, they are compelled for the most part to rely on the information and expert advice provided by the adviser and the majority directors.[11] The continued service of the statutorily disin-

[11] See Comment, supra note 9, at 702.

terested directors, for which in this case they were paid from $11,000 to $13,000 *per annum*[12], depends almost entirely on the establishment of satisfactory working arrangements between them and the majority responsible for their selection. It is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned.[13] Correspondingly, it cannot be expected that the public or the Fund's stockholders would believe that these five statutorily disinterested directors could act with that impartiality and objectivity which the public interest requires. It follows that disinterested directors of an investment company do not have the power to foreclose the continuation of nonfrivolous litigation brought by shareholders against majority directors for breach of their fiduciary duties. Of course here we do not reach the question of whether a court should defer to the decision of statutorily disinterested directors of an investment company to terminate a shareholder derivative suit which the court finds to be frivolous.

Our conclusion makes it unnecessary to consider the findings of the district court that the disinterested directors were sufficiently independent to determine that the litigation

[12] In addition to their role as directors of the Fund, each of the five minority directors served on the boards of five other Anchor affiliated funds, and all but one of the directors sat on a sixth Anchor related board.

[13] See *Fogel* v. *Chestnutt,* 533 F.2d 731, 750, (2d Cir. 1975); Nutt, A. Study of Mutual Fund Independent Directors, 120 U.Pa.L. Rev. 179, 216 (1971).

be ended.[14] We have no doubt that the five minority directors acted in good faith in all that they did.

Reversed and remanded for further proceedings.

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[14] Similarly, the plethora of cases cited by counsel dealing with the powers of boards of directors to terminate stockholder derivative suits and the effect of the demand requirement under Fed.R.Civ.P. 23.1 are inapposite. We base our decision on the unique nature of the investment company and its symbiotic relationship with its investment adviser, we need not reach questions of the exercise of similar power by directors of other types of corporations. Moreover, none of these cases involves the situation here, where the terminating directors owe their position as directors to the defendants in the suit.

COMPLAINT

Complaint

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

73 Civ. 552 (HFW)

HOWARD M. LASKER and IRVING GOLDBERG,

Plaintiffs,

against

HARRY G. BURKS, JR., EDWARD B. BURR, THOMAS F. CHALKER, JOHN R. HAIRE, HARVEY C. HOPKINS, S. P. HUTCHISON, DONALD L. KEMMERER, A. S. MIKE MONRONEY, CHARLES F. PHILLIPS, JEPTHA H. WADE, ANCHOR CORPORATION, and FUNDAMENTAL INVESTORS, INC.,

Defendants.

PLAINTIFFS DEMAND TRIAL BY JURY

Plaintiffs allege on information and belief, except as to Paragraphs 2 and 6, which are alleged upon knowledge by each of said plaintiffs:

1. The jurisdiction of this Court over this action is based upon Section 44 of the Investment Company Act of 1940 (15 U.S.C. § 80a-43), Section 214 of the Investment Advisers Act of 1940 (15 U.S.C. § 80b-14) and principles of pendent jurisdiction.

2. Plaintiff Howard M. Lasker is, and at the time of the transactions complained of was, the beneficial owner of shares of Fundamental Investors, Inc. (the "Fund").

Plaintiff Irving Goldberg is, and at the time of the transactions complained of was, the record owner of shares of the Fund. Plaintiffs bring this action derivatively on behalf and in the right of the Fund.

3. The Fund is, and at the time of the transactions complained of was, a corporation organized under the laws of the State of Delaware and a registered investment company under the Investment Company Act of 1940.

4. Defendant Anchor Corporation (the "Adviser") is, and at the time of the transactions complained of was, a corporation organized under the laws of the State of Delaware and a registered investment adviser under the Investment Advisers Act of 1940.

5. Defendants Harry G. Burks, Jr., Edward B. Burr, Thomas F. Chalker, John R. Haire, Harvey C. Hopkins, S. P. Hutchison, Donald L. Kemmerer, A. S. Mike Monroney, Charles F. Phillips and Jeptha H. Wade (the "Fund directors") were directors of the Fund at all times mentioned.

6. This action is not brought collusively to confer upon this Court jurisdiction which it otherwise would not have and plaintiffs will fairly and adequately represent the interests of the Fund and its stockholders in enforcing the Fund's rights.

7. (a) No demand has been made by the plaintiffs upon the Board of Directors of the Fund to institute this action against the individual defendants and the Adviser because the Fund's Board of Directors is dominated and controlled by the Adviser and the individual defendants continue to be a majority of the Fund's Board of Directors and they have

participated, cooperated and aided and abetted in the wrongful acts, transactions and delinquencies complained of. No action could or would be permitted to be instituted by the Fund without the consent of the Fund directors. The Fund's Board of Directors for a considerable time has been fully aware of the wrongful acts herein alleged and has nevertheless failed to take action. Consequently, any demand upon the Fund's Board of Directors would be futile and useless and any such action that would be instituted by the Board of Directors on behalf of the Fund would be friendly to the defendants, would not be diligently prosecuted and would be hostile to the interests of the Fund and its stockholders.

(b) No demand has been made upon the stockholders of the Fund to institute this action on behalf of the Fund because under applicable law and the certificate of incorporation and by-laws of the Fund, its directors and officers are vested with the management of the Fund, including the institution of all actions on behalf of the Fund, and the stockholders as a body cannot by resolution compel the directors to institute suit on behalf of the Fund. A resolution by the stockholders of the Fund directing the institution of this action would be futile and useless because the prosecution of the action would be placed in the control of the Fund's Board of Directors, the majority of whom are defendants and who had knowledge of and participated, cooperated and aided and abetted in the wrongs alleged herein. Furthermore, the stockholders of the Fund are very numerous and the solicitation of proxies from such a large number of stockholders would place an unreasonable and useless burden and expense on plaintiffs, and extended delays would result which would be harmful and seriously prejudicial to the prosecution of this action.

FIRST CLAIM FOR RELIEF

8. Plaintiffs repeat and reallege Paragraphs 1 through 7 of the Complaint.

9. This claim arises under Section 36 of the Investment Company Act of 1940.

10. On the following dates and in the amounts indicated, the Fund purchased interest bearing commercial paper of Penn Central Transportation Company ("Penn Central") in the Southern District of New York from Goldman, Sachs & Co. ("Goldman, Sachs"), which acted as principal, by use of the mails and the means and instrumentalities of interstate commerce:

Date of Purchase	Amount of Purchase
November 28, 1969	$ 5,000,000
December 2, 1969	5,000,000
December 4, 1969	5,000,000
December 8, 1969	5,000,000
	$20,000,000

11. At all relevant times the Fund directors were responsible for determining the basic investment policies of the Fund and the Adviser acted as investment adviser to the Fund and was responsible for making recommendations to the Fund with respect to purchase and sale of all investments, including commercial paper. During 1969 the Adviser received, pursuant to its investment advisory contract, in excess of $4,500,000 from the Fund for investment supervisory and corporate administrative services and in excess of $300,000 in net sales commissions as principal underwriter of the Fund's shares.

12. In making the purchases alleged in Paragraph 10, the Fund directors and the Adviser relied solely and exclusively on Goldman, Sachs and made no independent investigation of the financial condition of Penn Central or the quality of its commercial paper including, where feasible, among other things, the following: examination and analysis of quarterly or more frequent financial statements; calculation of debt-equity ratios; obtaining of lists of open bank lines of credit and inquiry as to whether any such were used; calculation of the ratio of current assets to current liabilities; examination and analysis of debt position to check for defaults; review of the appropriate Docket of the Interstate Commerce Commission with respect to the proposed issuance of commercial paper by Penn Central; verifying creditworthiness of issuer with custodian bank; inquiry with respect to maximum amount of bank lines of credit ever used; examination of percentage of commercial paper outstanding backed by usable lines of credit; obtaining cash flow statement, if available. In failing to make the foregoing investigation, the Adviser failed to meet its responsibility as the Fund's investment adviser, for which investment management and advice it received the very substantial compensation set forth in Paragraph 11. The Fund directors knew or should have known of, and acquiesced in, the failure by the Adviser to meet its responsibility and failed to meet their responsibilities as members of the Fund's Board of Directors.

13. If the Fund directors and the Adviser had made an independent investigation of the financial condition of Penn Central and the quality of its commercial paper in connection with the Fund's purchase of Penn Central commercial paper (including a review of material available in

the public press), they would have learned at least the following material adverse facts.

(a) The commercial paper of Penn Central was not prime quality commercial paper;

(b) Goldman, Sachs had made inadequate independent investigation of the financial condition and affairs of Penn Central and was not continually reviewing the same to ascertain whether Penn Central commercial paper was of prime quality or to evaluate the advisability of purchases of said commercial paper by the Fund;

(c) Penn Central had for some time been facing severe cash shortages and difficulties in obtaining financing to meet its operating expenses, improvement costs and debt maturities;

(d) Penn Central had for some time been unable to obtain long-term financing and had, since at least as early as 1968, become almost completely dependent upon short-term, high interest financing, had been required to maintain substantial compensating balances at its lending banks and had no present prospects for obtaining long-term financing;

(e) Penn Central had virtually exhausted all possibilities to obtain bank loans, had already pledged virtually all of its assets to its bank creditors and had no assets to pledge or otherwise use to obtain further loans or financing or to cover or meet its commercial paper obligations;

(f) Penn Central was using the funds which it obtained from the sales of its commercial paper to

refinance its debt maturities rather than for its current operating expenses;

(g) Penn Central was undergoing extraordinarily large and rapidly increasing operating losses and working capital deficits;

(h) During 1970 Penn Central would have to have available far in excess of $200,000,000 merely to meet debt maturities and interest costs and would have to raise other substantial and unavailable sums to meet its other anticipated expenses;

(i) In an application by Penn Central to the Interstate Commerce Commission for approval to issue commercial paper, the Interstate Commerce Commission and its staff had expressed serious concern over the heavy dependence of Penn Central upon short-term financing;

(j) Penn Central had no firm commitments by commercial banks to assure that it would have sufficient funds to redeem its outstanding commercial paper at maturity, and did not have bank lines of credit sufficient for that purpose;

(k) Most banks were at or near their legal or practical lending limits with respect to Penn Central and were looking to reductions of their loans rather than increases and it was highly doubtful that Penn Central could obtain authorization from the Interstate Commerce Commission to issue additional commercial paper beyond the $200,000,000 then authorized;

(l) In November 1969 Penn Central reported a loss of approximately $40,200,000 for the first nine

months of 1969 as compared to a loss of approximately \$13,800,000 for the comparable period in 1968;

(m) On or about November 29, 1969, the Board of Directors of Penn Central's parent company omitted that corporation's regular fourth quarter dividend.

14. On June 21, 1970 Penn Central filed a petition for reorganization under Section 77 of the Bankruptcy Act (11 U.S.C. § 205).

15. The Penn Central commercial paper held by the Fund was not paid at maturity and is presently in default and the Fund has not received any payment with respect to such commercial paper up to the date of this Complaint, thereby resulting in a loss to the Fund of \$20,000,000 plus accrued interest.

16. By reason of the foregoing, defendants, in contravention of Section 36 of the Investment Company Act of 1940, engaged in acts and practices constituting gross misconduct and a gross abuse of trust in respect of the Fund.

Second Claim For Relief

17. Plaintiffs repeat and reallege Paragraphs 1 through 7 and Paragraphs 10 through 15 of the Complaint.

18. This claim arises under Section 206 of the Investment Advisers Act of 1940.

19. By reason of the foregoing, the Adviser, in contravention of Section 206 of the Investment Advisers Act of

1940, by use of the mails and the means and instrumentalities of interstate commerce, engaged in transactions, practices and a course of conduct which operated as a fraud and deceit upon the Fund and engaged in acts, practices and a course of conduct which were fraudulent.

Third Claim For Relief

20. Plaintiffs repeat and reallege Paragraphs 1 through 7 and Paragraphs 10 through 15 of the Complaint.

21. By reason of the foregoing, the defendants violated their common law fiduciary duty to the Fund and are jointly and severally liable and accountable to the Fund for all loss and damage which it has suffered and will suffer by reason of the acts, transactions and delinquencies complained of.

Fourth Claim For Relief

22. Plaintiffs repeat and reallege Paragraphs 1 through 7 and Paragraphs 10 through 15 of the Complaint.

23. By reason of the foregoing, the Adviser breached its investment advisory contract with the Fund and the Fund directors participated and aided and abetted in the breach of said investment advisory contract in that the Adviser failed to make an independent investigation of the financial condition of Penn Central and the quality and safety of its commercial paper and the Fund directors acquiesced in such failure, thereby damaging the Fund as alleged, and the defendants are jointly and severally liable

and accountable to the Fund for all loss and damage which it has suffered and will suffer by reason of the breach of the investment advisory contract complained of.

Fifth Claim For Relief

24. Plaintiffs repeat and reallege Paragraphs 1 through 7 and Paragraphs 10 through 15 of the Complaint.

25. This claim arises under Section 36 of the Investment Company Act of 1940.

26. From November 28, 1969 to June 21, 1970, the date of the filing of a petition for the reorganization of Penn Central under Section 77 of the Bankruptcy Act, the financial condition of Penn Central worsened steadily and Penn Central commercial paper became an increasingly poor investment.

27. During the period from November 28, 1969 to June 21, 1970, the Adviser and the Fund directors failed to commence a thorough and adequate investigation of, and keep under continuous review, the financial condition of Penn Central and the quality and safety of its commercial paper.

28. If such investigation and review had been made (including a review of material available in the public press), the Adviser and the Fund directors would have learned at least the material adverse facts, among others, set forth at subparagraphs (a)-(m), inclusive, of Paragraph 13 of this Complaint as well as at least the following material adverse facts:

(a) Penn Central's losses for 1969 had increased to approximately \$56,300,000 from approximately \$5,100,000 for 1968;

(b) The losses of Penn Central for the first quarter of 1970 were approximately \$62,700,000;

(c) On or about February 12, 1970, Penn Central repurchased at face value \$10,000,000 of its commercial paper from Goldman, Sachs;

(d) Penn Central had virtually exhausted its ability to obtain short term financing in the United States;

(e) Penn Central and its parent company had begun to borrow heavily at high interest rates in Europe from borrowers who were relatively unsophisticated about Penn Central;

(f) On or about April 22, 1970, there commenced a rapid run on Penn Central commercial paper and it became virtually impossible for Goldman, Sachs to resell Penn Central commercial paper as it became due;

(g) On or about May 9, 1970, high Penn Central officials met with the Secretary of the Treasury with respect to emergency Government assistance for the failing railroad;

(h) On or about May 15, 1970 Standard and Poor's reduced the credit rating of Penn Central's parent company from BBB to BB.

29. During the period from November 28, 1969 to June 21, 1970, the Fund directors failed in their obligations to make adequate attempts to resell (as did Goldman, Sachs as referred to in subparagraph (c) of Paragraph 28) the Penn Central commercial paper held by the Fund and the Adviser failed to advise the Fund of the advisability of making such attempts.

30. During the period from November 28, 1969 through June 21, 1970, the Adviser, pursuant to its investment advisory contract, continued to be compensated by the Fund for investment supervisory and corporate administrative services at an annual rate in excess of $4,500,000 and continued to receive net sales commissions as principal underwriter of the Fund's shares at an annual rate in excess of $300,000.

31. By reason of the foregoing, defendants, in contravention of Section 36 of the Investment Company Act of 1940, engaged in acts and practices constituting gross misconduct and a gross abuse of trust in respect of the Fund.

Sixth Claim For Relief

32. Plaintiffs repeat and reallege Paragraphs 1 through 7, Paragraphs 10 through 15 and Paragraphs 26 through 30 of the Complaint.

33. This claim arises under Section 206 of the Investment Advisers Act of 1940.

34. By reason of the foregoing, the Adviser, in contravention of Section 206 of the Investment Advisers Act of 1940, by the use of the mails and the means and instrumentalities of interstate commerce, engaged in transactions, practices and a course of conduct which operated as a fraud and deceit upon the Fund and engaged in acts, practices and a course of conduct which were fraudulent.

Seventh Claim For Relief

35. Plaintiffs repeat and reallege Paragraphs 1 through 7, Paragraphs 10 through 15 and Paragraphs 26 through 30 of the Complaint.

36. By reason of the foregoing, the defendants violated their common law fiduciary duty to the Fund and are jointly and severally liable and accountable to the Fund for all loss and damage which it has suffered and will suffer by reason of the acts, transactions and delinquencies complained of.

Eighth Claim For Relief

37. Plaintiffs repeat and reallege Paragraphs 1 through 7, Paragraphs 10 through 15 and Paragraphs 26 through 30 of the Complaint.

38. By reason of the foregoing, the Adviser breached its investment advisory contract with the Fund and the Fund directors participated and aided and abetted in the breach of said investment advisory contract in that the Adviser failed to commence a thorough and adequate investigation of, and keep under continuous review, the financial condition of Penn Central and the quality and safety of its commercial paper and the Fund directors acquiesced in such failure, thereby damaging the Fund as alleged, and the defendants are jointly and severally liable and accountable to the Fund for all loss and damage which it has suffered and will suffer by reason of the breach of the investment advisory contract complained of.

Ninth Claim For Relief

39. Plaintiffs repeat and reallege Paragraphs 1 through 17, Paragraphs 10 through 15 and Paragraphs 26 through 30 of the Complaint.

40. This claim arises under Section 13(a)(3) of the Investment Company Act of 1940.

41. The Fund's registration statement filed with the Securities and Exchange Commission pursuant to Section 8(b) of the Investment Company Act of 1940 states, as a fundamental policy, that the Fund may not hold more than 10% of the securities (voting and non-voting) of any one issuer.

42. During the period from November 28, 1969 to June 21, 1970, the date of the filing of a petition for reorganization of Penn Central under Section 77 of the Bankruptcy Act, the outstanding commercial paper of Penn Central dropped from $200,000,000 to approximately $82,000,000.

43. The $20,000,000 of Penn Central commercial paper held by the Fund constituted the holding of more than 10% of the securities of a single issuer.

44. The Fund directors and the Adviser failed in their responsibility to ascertain that the Fund's holding of Penn Central commercial paper deviated from the fundamental policy set forth in the Fund's registration statement filed with the Securities and Exchange Commission pursuant to Section 8(b)(2) of the Investment Company Act of 1940.

45. By reason of the foregoing, the defendants, in contravention of Section 13(a)(3) of the Investment Company Act of 1940, caused the Fund to deviate from the fundamental policy recited in its registration statement filed with the Securities and Exchange Commission pursuant to Section 8(b)(2) of the Investment Company Act of 1940.

WHEREFORE, plaintiffs demand judgment against the defendants as follows:

(a) That the Fund directors and the Adviser be required to account to the Fund for all loss and

damage sustained and to be sustained by the Fund as a result of the wrongful acts, transactions and delinquencies complained of.

(b) That plaintiffs recover the costs and disbursements of this action including reasonable fees to plaintiffs' attorneys and accountants.

(c) That plaintiffs have such other and further relief as may be just and proper.

ARANOW, BRODSKY, BOHLINGER,
BENETAR, EINHORN & DANN

By s/ HERBERT A. EINHORN
(A Member of the Firm)
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(Verification)

PAPERS ON MOTION TO DISMISS

Affidavit of Roger T. Wickers, Sworn to January 27, 1975 in Support of Motion to Dismiss

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

73 Civ. 552 (HFW)

———o———

HOWARD M. LASKER, et ano.,

Plaintiffs,

against

HARRY G. BURKS, JR., et al.,

Defendants.

———o———

STATE OF NEW YORK }
COUNTY OF NEW YORK } ss.:

ROGER T. WICKERS, being duly sworn, deposes and says:

1. I am Senior Vice President of Fundamental Investors, Inc. ("Fundamental"), the party on whose behalf this derivative action is allegedly brought, and I submit this affidavit in support of the motion by Fundamental to dismiss this action.

2. I have personal knowledge of the facts set forth in this affidavit, and I bring them to the attention of this Court to supplement the principal moving affidavit of Leon T. Kendall, sworn to January 23, 1975.

3. Fundamental is an open-end investment company (commonly known as a "mutual fund") registered under the Investment Company Act of 1940.

4. Anchor Corporation ("Anchor") is the investment adviser to Fundamental.

5. On November 26, 1969 Fundamental, which had a portfolio at that time worth approximately one billion dollars, purchased from Goldman, Sachs & Co., a commercial paper dealer, $20 million of 270-day notes of Penn Central Transportation Company as a short-term investment of unemployed cash.*

6. On June 21, 1970 Penn Central Transportation Company filed a Petition for Reorganization under the federal bankruptcy laws, and the notes were not paid at maturity, nor have they been paid to date. Penn Central Transportation Company is still in the process of being reorganized under the jurisdiction of Honorable John R. Fullam, United States District Judge for the Eastern District of Pennsylvania.

7. On November 4, 1970 Fundamental initiated an action, with three other plaintiffs,** in the United States District Court for the Southern District of New York against Goldman, Sachs & Co. ("the *Welch* action") for rescission of their purchases of the notes of Penn Central Transportation Company. The Board of Directors of Fundamental has kept this matter under continuous review since that time.

8. Nearly three years after the purchase of the Penn Central Transportation Company commercial paper by Fundamental, two stockholders of Fundamental commenced

* The purchase was actually made in four $5,000,000 amounts on November 26, December 2, 4 and 8, 1969.

** The three other plaintiffs were Welch Foods Inc., C. R. Anthony Company and Younker Brothers.

the instant derivative action ("the *Lasker* action") allegedly on behalf of Fundamental. On July 30, 1973, on motion of all defendants, Judge Gurfein stayed the *Lasker* action pending the resolution of the claims of Fundamental in the *Welch* action.

9. On July 9, 1974 the claims of Fundamental in the *Welch* action were settled as follows: Goldman, Sachs & Co. took back the notes, paid Fundamental $5,250,000 in cash and assigned to Fundamental a 73.75% interest in the proceeds of the $20 million of notes in the reorganization proceedings.

10. On July 24, 1974, following the settlement of the claims of Fundamental in the *Welch* action, the Board of Directors of Fundamental retained Honorable Stanley H. Fuld, former Chief Judge of the State of New York as Special Counsel to advise and consult with it regarding this matter.

11. On December 18, 1974 and January 6, 1975, the Board of Directors of Fundamental met at special meetings. Following the deliberations, described in detail in the Kendall affidavit, by a wholly disinterested quorum consisting of five members of the Board of Directors,* none of whom was a director at the time of the events complained of and none of whom is a defendant in the *Lasker* action, the Board of Directors, acting solely by these five wholly disinterested persons, resolved that it was not in the best interests of the shareholders of Fundamental for the *Lasker* action to

* The five wholly disinterested directors are: Leon T. Kendall, Louis F. Laun, Mary S. O'Connor, Beryl Robichaud and William J. Stephens.

Affidavit of Wickers in Support of Motion to Dismiss

continue against Anchor and the other defendants, and instructed litigation counsel to Fundamental in this action (Messrs. Seward & Kissel) to move to dismiss this action.

All other defendants have joined in this motion by Fundamental.

Conclusion

The Board of Directors of Fundamental, acting by a wholly disinterested quorum, has determined that in its business judgment, this action allegedly brought on behalf of Fundamental is contrary to the best interests of Fundamental and its shareholders. Accordingly, this action should be dismissed.

s/ Roger T. Wickers

Sworn to before me
January 27, 1975

Affidavit of Leon T. Kendall, Sworn to January 23, 1975, in Support of Motion to Dimiss

UNITED STATES DISTRICT COURT

Southern District of New York

73 Civ. 552 (HFW)

———0———

Howard M. Lasker, et ano.,

Plaintiffs,

against

Harry G. Burks, Jr., et al.,

Defendants.

———0———

State of New York }
County of New York } ss.:

Leon T. Kendall, being duly sworn, deposes and says:

1. I am a director of Fundamental Investors, Inc. ("Fundamental"), the mutual fund on whose behalf this derivative action has allegedly been brought. I am fully familiar with the facts set forth below and make this affidavit in support of Fundamental's motion to dismiss this action. The basis of this motion is that by unanimous vote the Board of Directors of Fundamental (acting by a wholly disinterested quorum) determined that this action is contrary to the best interests of the shareholders of Fundamental.

2. I attended the meeting of the Board of Directors of Fundamental held on July 24, 1974. Following a discussion of the settlement of Fundamental's action against Goldman, Sachs & Co. ("the *Welch* action"), the Board of Directors reviewed the status of this action. The Board of Directors determined that the five directors who (a) are not affiliated in any way with the investment adviser, Anchor Corporation ("Anchor"), (b) were not directors at the time of the events alleged in the complaint and (c) are not defendants in this action ("the five disinterested directors") would.

acting as a quorum pursuant to the by-laws, constitute the Board of Directors to decide what position Fundamental should take regarding this action.

The Five Disinterested Directors

3. For the Court's information, the following is a brief description of the five disinterested directors, together with the year in which each became a director:

Name	Year Elected to Board	Background
Leon T. Kendall	1974	President of Mortgage Guaranty Insurance Corporation, Milwaukee, Wisconsin (a New York Stock Exchange listed company with assets approaching $800,000,000). Vice President and Economist of the New York Stock Exchange from 1964 to 1967. President of the Association of Stock Exchange Firms from 1967 to 1972 and thereafter President of The Securities Industry Association until 1974.
Louis F. Laun	1971	Deputy Administrator of the Small Business Administration, Washington, D.C.; until 1971, Vice President of Celanese Corporation, manufacturer of synthetic fibers.
Mary S. O'Connor	1972	Director and Member of the Executive and Trust Committees of the Central Home Trust Company of Elizabeth, New Jersey, since 1959; Assistant Vice President of International Business Machines Corporation from 1943 to 1947.
Dr. Beryl Robichaud	1973	Senior Vice President, McGraw-Hill, Inc., New York, New York. Director, Aetna Life and Casualty Corporation.
William J. Stephens	1973	Director, Jones and Laughlin Steel Corporation, Pittsburgh, Pennsylvania; until 1972, Chairman and Chief Executive Officer of Jones and Laughlin Steel Corporation. Director, Equitable Gas Company, Pittsburgh.

Retention of Chief Judge Fuld as Special Counsel

4. To assist in our consideration, at the July 24 meeting, we five decided to retain special counsel. Pursuant to that decision, after reviewing his background and qualifications, we retained Hon. Stanley H. Fuld, former Chief Judge of the State of New York, to review all of the relevant aspects of this matter and to analyze the pertinent facts and relevant law and authorities. A copy of a biographical sketch of Chief Judge Fuld is attached as Exhibit A.

5. After several months of investigation, Chief Judge Fuld reported the results of his analysis of the facts and law in a memorandum dated December 5, 1974, a copy of which is attached as Exhibit B. Chief Judge Fuld reported that he had reviewed the complaint in this action and the relevant documents and depositions in the *Welch* action. He had also reviewed the files of Fundamental and Anchor relating to the purchase of the Penn Central commercial paper, and interviewed officers of Fundamental and Anchor who had knowledge of the relevant events. In addition, Chief Judge Fuld reviewed the corporate documents of Fundamental, studied the applicable statutes and regulations and conducted the necessary legal research.

6. Chief Judge Fuld advised us that

> "As a result of my analysis of the facts and the law, it is my opinion that there was no violation by Anchor or by the Fund directors of any provision of statute or of any common law or contractual obligation to the Fund, in connection with the acquisition and retention of the Penn Central commercial paper." (p. 2).

7. After receiving Chief Judge Fuld's December 5, 1974 opinion, each of us carefully reviewed it and several of us had questions regarding the subjects covered in the opinion and the alternatives which were available to the directors of Fundamental.

8. In response to questions raised by the five disinterested directors and on further review of his own, on December 18, 1974 Chief Judge Fuld delivered a supplemental analysis and opinion to the Board. A copy of his supplemental analysis and opinion is annexed as Exhibit C. Chief Judge Fuld had advised in his December 5 memorandum that it was up to the five disinterested directors, in the exercise of their discretion and business judgment, to determine what course Fundamental should follow. As previously noted, Chief Judge Fuld had advised us that in his opinion there was no violation of law by Anchor or by the directors of Fundamental. In his supplemental opinion, he went on to add that even if there were a possible claim, Fundamental did not necessarily have to prosecute that claim: he advised us that whether or not a corporation seeks to enforce in the courts a cause of action for damages is, like other business questions, a matter of internal management and is left to the discretion of the directors.

The December 18, 1974 Meeting:
Exploration of the Facts and Law

9. After receiving Chief Judge Fuld's supplemental opinion of December 18, 1974, the five disinterested directors met alone in a series of special meetings devoted exclusively to this subject. In that first special meeting I was designated to be Chairman of the five disinterested directors. We reviewed the supplemental opinion and discussed further the questions each of us had with respect to the facts, the law and the alternatives available. We also determined the procedure we would follow in conducting our inquiry, including the subjects to be dealt with, the order in which we would deal with them and whom we would question.

10. Following our private discussion, we invited the following persons to join the special meeting for the purpose of responding to our questions: Chief Judge Fuld; John R. Haire, Chairman and Chief Executive of Anchor; Donald L. Kemmerer and Charles F. Phillips, who are, and at the time of the events complained of, were unaffiliated directors of Fundamental; and Eugene P. Souther, Esq., litigation counsel to Fundamental in this action. As Chairman, I presided at that meeting and Mr. Souther served as Secretary. Minutes of that special meeting are annexed as Exhibit D.

11. The attached minutes show the order in which we proceeded in that meeting and the substance of our discussions. Each of us had given substantial consideration to the issues in preparation for the meeting and we pursued our questions in what I believe was a thoughtful and searching fashion.

12. The five disinterested directors asked Chief Judge Fuld, among other things, for his opinion as to (a) the merits of each of the claims made in this action, (b) whether Anchor had followed proper procedure under the circumstances at the time in determining to purchase and retain the Penn Central commercial paper, (c) the standards the

five disinterested directors should apply in determining what course of action to pursue, and (d) the alternatives available to the Board. Chief Judge Fuld gave us his opinion on these subjects and emphasized that in making our decision we should exercise our good faith business judgment as to what was in the best interests of the shareholders of Fundamental.

13. Our questions to Mr. Souther pertained to the practical implications of each alternative. We discussed the nature and extent of pre-trial discovery and trial preparation to be expected, the cost, and the business interruption that might be experienced by Anchor and how that might adversely affect the interest of the shareholders of Fundamental. We also discussed the effect, if any, of the earlier decision of the Board of Directors to settle its case against Goldman, Sachs, and the subsequent jury award to the remaining plaintiffs in the *Welch* action.

14. We then interrogated John Haire. Our discussions with him are summarized in the annexed minutes and, to avoid repetition, will not be detailed here. Suffice it to say that the five disinterested directors had thought long and hard about the questions before them. All of us had carefully reviewed Chief Judge Fuld's thoughtful analysis. So armed, and with the advantage of hindsight, we critically examined the decision to purchase the Penn Central commercial paper, the information available to Anchor at the time, the consideration Anchor gave before purchasing that paper, the procedure Anchor followed in making the investment, the information available to the Board of Directors at the time with respect to that purchase and other purchases of commercial paper, the identity of other "sophisticated investors" who had purchased Penn Central commercial paper during the relevant period, the identity of those purchasers of such paper who held it at the time of the Penn Central reorganization, the anticipated effect on the shareholders of Fundamental if this action were to be prosecuted either under the control of Fundamental or under the control of the two shareholders who brought it, the anticipated effect on the investment adviser from the continued prosecution of the action and how that would affect Fundamental's shareholders, and the ability of Anchor to respond in damages should a judgment against it be obtained.

15. After excusing Messrs. Phillips, Kemmerer and Haire, we five continued our discussion with Chief Judge Fuld, reviewing the subjects which had been considered during the earlier part of the meeting and the criteria we should apply in reaching our decision.

16. When there were no more questions, we excused Chief Judge Fuld and Mr. Souther. In that private portion of the meeting we agreed that we wished to give further consideration to the subject and adopted a procedure for that consideration. Each director would give further separate thought to the matter and convey any additional questions to me for response. I was to secure replies to these questions through our special counsel and litigation counsel. We agreed not to have any contact with anyone affiliated with Anchor until we had reached our decision.

December 18, 1974—January 6, 1975: Further Reflection by the Disinterested Directors

17. During late December and early January I personally spoke by telephone with each of the other four dis-

interested directors and gathered the questions they wanted answered. Indicative of the consideration we were each giving to the matter is the letter written to each of us by William J. Stephens on December 31, 1974. A copy of that letter is attached as Exhibit E.

18. I reviewed the questions for Chief Judge Fuld in a conference call with him and Mr. Souther on January 3, 1975. The essence of that conversation was to reconfirm that we were to make our decision, whatever it was to be, in the exercise of our good faith business judgment as to what was in the best interests of the shareholders of Fundamental. Because the telephone connection at times was not satisfactory, I thereafter personally spoke with Chief Judge Fuld and repeated the discussion.

The Meeting of January 6, 1975:
The Vote to Dismiss

19. The second special meeting of the Board of Directors to review this subject was held on January 6, 1975. The other directors present were: Louis F. Laun, Dr. Beryl Robichaud and William J. Stephens. Mrs. Mary S. O'Connor was abroad, but she and I had spoken by telephone and she had told me her decision as to the action Fundamental should take. In addition, Mr. Souther was also present to act as Secretary of the meeting.

20. Following the review and approval of the minutes of the first special meeting, I reported to the Board the events that had transpired since our last meeting, including my telephone conversation on January 3 with Chief Judge Fuld. Mr. Souther then replied to certain questions from Board members. The questions and his answers are summarized in the minutes of that special meeting, a copy of which is attached as Exhibit F. We all confirmed that we had not communicated with any officer or employee of Anchor since the December 18, 1974, special meeting.

21. We then reviewed in detail each of the alternatives available to Fundamental. Our consideration is summarized in the minutes of the meeting. Our overriding and only consideration was what course was in the best interests of the shareholders of Fundamental.

22. We decided that the prosecution of this action was contrary to the best interests of the shareholders of Fundamental and that counsel should be directed to seek to dismiss the action. Among the factors we considered were:

(a) Chief Judge Fuld's opinion that there is no merit to the action and little likelihood of its success;

(b) The business interruption to Anchor, distraction of its personnel and the likely inability for it to attract and maintain personnel during pendency of the action necessarily would be harmful to the shareholders of Fundamental;

(c) If the action were to proceed against Anchor with the acquiescence or under the control of Fundamental, the adversary relationship that would be created between Fundamental and Anchor and the attendant serious distraction of Anchor's personnel from their efforts on behalf of the shareholders of Fundamental would leave us no practical alternative

but to remove Anchor as investment adviser and to seek to retain a new investment adviser; this would necessarily result in delay, uncertainty and an inevitable lapse in the management of Fundamental's affairs to the serious detriment of its shareholders;

(d) Anchor had acted in good faith and in what it believed was in the best interests of Fundamental's shareholders in purchasing the Penn Central commercial paper;

(e) Anchor had acted reasonably and had followed procedures prudent at the time in light of the then generally held belief that commercial paper was equivalent to cash;

(f) A vast number of other institutional investors, including many major banks in New York City and throughout the country and certain major mutual funds, had also believed that Penn Central was a sound business enterprise and had purchased Penn Central commercial paper at the time, and many such investors still held that paper when Penn Central petitioned for reorganization;

(g) To take no position at all and thereby to allow two of the more than 90,000 shareholders to determine the course of this action would not be a decision at all, but an avoidance of our obligation to all the shareholders;

(h) Chief Judge Fuld's advice that an investment adviser is not a guarantor of the investments it makes and can only be charged for breaches of contract or of the standards applied by the pertinent

statutes and regulations. Chief Judge Fuld had analyzed the facts and law and had concluded that Anchor was not at fault and that there was little likelihood that Anchor would be held to have violated any statute or regulation or to have breached any agreement or duty;

(i) Given Chief Judge Fuld's opinion, if the action were to proceed, there could be unnecessary costs to the shareholders of Fundamental for legal fees, both for its own counsel and for the director defendants, who would be entitled to reimbursement of counsel fees if they were found not to be liable to Fundamental; and

(j) Even if there were a recovery of the theoretical maximum amount of damages, the net result to the shareholders of Fundamental would be little more than a net recovery of 10 cents per share, or approximately 2% of Fundamental's net asset value. The remote chance of recovering that small amount was not worth the risk of the serious damage to Fundamental's shareholders which proceeding with this action might produce.

23. After several hours of consideration, on motion of Mr. Louis F. Laun, seconded by Dr. Beryl Robichaud, the five disinterested directors (Mrs. O'Connor's vote being cast by me in accordance with her instructions to me*) unanimously decided to instruct counsel to move to dismiss the action as being contrary to the best interests of the shareholders of Fundamental.

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* Mrs. O'Connor reaffirmed her vote in the presence of all of us at a special meeting held for that purpose on January 22, 1975.

24. I therefore respectfully urge that this Court grant Fundamental's motion to dismiss the complaint.

s/ LEON T. KENDALL

Sworn to before me
January 23, 1975

Central commercial paper. At the outset I set forth the relevant facts which, despite the volume of material involved, may be summarized relatively briefly, and then consider the applicable law and the possible courses of action to be followed by the current Fund directors.

FACTS

The Fund has in recent years had large amounts of cash on hand, partly to be available to pay for securities

[1] The action by the Fund resulted in a settlement described below (*infra*, p. 9).

Exhibit B to Affidavit of Leon T. Kendall, sworn to January 23, 1975—Report of Stanley H. Fuld to Board of Directors of Fundamental Investors, Inc. dated December 5, 1974

(Letterhead of)
STANLEY H. FULD
425 Park Avenue
New York, N.Y. 10022

December 5, 1974

PRIVILEGED AND CONFIDENTIAL
Board of Directors
of Fundamental Investors, Inc.
Westminster at Parker
Elizabeth, New Jersey

Dear Sirs:

In November and December of 1969, Fundamental Investors, Inc. (the "Fund") purchased, in four separate lots, commercial paper of Penn Central Transportation Company ("Penn Central") from Goldman, Sachs & Co., in the aggregate amount of $20,000,000. On June 21, 1970, Penn Central filed a petition for reorganization under Section 77 of the Bankruptcy Act, and the commercial paper was not paid at maturity.

In February, 1973, a stockholders' derivative suit was brought against Anchor Corporation ("Anchor"), the Fund and the directors of the latter, based in substance on the claim that Anchor (the Fund's investment adviser) and the Fund's directors, in both the purchase and the retention of the Penn Central commercial paper, breached statutory and other obligations to the Fund by virtue of the fact that they "relied solely and exclusively on Goldman, Sachs and made no independent investigation of the finances of Penn Central or the quality of its commercial paper." (see p. 10 below).

You retained me as special counsel to advise you with respect to the future course of action to be followed in connection with the investment made by the Fund in the commercial paper of Penn Central.

I have reviewed the complaint in the derivative action, the relevant pleadings and depositions in the action entitled "*Welch Foods, Inc., et al.* v. *Goldman, Sachs & Co.*" brought by several parties, including the Fund, in the United States District Court for the Southern District of New York.[1] I have also had the files of the Fund and of its adviser, Anchor, relating to the purchase of that commercial paper reviewed. I have interviewed certain officers and employees of the Fund and have also had certain other officers and employees of the Fund interviewed, the Fund's constituent documents and the applicable statutes and regulations reviewed, and the necessary legal research conducted.

As a result of my analysis of the facts and the law, it is my opinion that there was no violation by Anchor or by the Fund directors of any provision of statute or of any common law or contractual obligation to the Fund, in connection with the acquisition and retention of the Penn Central commercial paper. At the outset I set forth the relevant facts which, despite the volume of material involved, may be summarized relatively briefly, and then consider the applicable law and the possible courses of action to be followed by the current Fund directors.

Facts

The Fund has in recent years had large amounts of cash on hand, partly to be available to pay for securities

[1] The action by the Fund resulted in a settlement described below (*infra*, p. 9).

which the Fund managers found it desirable to purchase, and partly to be available for redemptions of Fund shares. During the latter part of 1965 Anchor, in order to increase the Fund's income, began to invest part of its temporarily idle cash in commercial paper. Responsibility for determining the amounts and maturities of the commercial paper purchased was placed in the office of the Fund's Treasurer, an employee of Anchor, who, in consultation with the various Fund managers and in the light of their projected purchases and of other cash needs of the Fund, decided how much money could be invested and for how many days.

Until the Fall of 1969 all commercial paper was purchased directly from among a group of eight issuers initially selected and approved by the Fund's Investment Committee.[2] In order to provide added liquidity in case of an unexpected need for cash by the Fund, the Treasurer insisted that each issuer agree to repurchase its paper from the Fund on demand. Purchases were made on virtually a daily basis, and officials of these issuers were in frequent telephone communication with the Fund's Treasurer, to negotiate the amounts, rates and maturities of paper which might be purchased by the Fund. Because he was continually purchasing paper from these companies, the Treasurer sought, through periodic questioning of these officials, review of published quarterly financial statements and inquiry of the Fund's bank custodian, to keep current on the credit status of the issuers, including the

[2] These eight companies were among the nation's major finance companies: General Motors Acceptance Corporation, Sears Roebuck Acceptance Corp., Montgomery Ward Credit Corp., J. C. Penney Credit Corporation (now J. C. Penney Financial Corporation), C.I.T. Financial Corporation, Commercial Credit Co., Ford Motor Credit Company, and Chrysler Financial Corporation.

extent of their outstanding commercial paper and of their unused bank lines.

From time to time Anchor was solicited by dealers who sought to sell to the Fund the commercial paper of industrial companies which did not sell their paper directly. Initially the paper sold by dealers offered substantially the same rate of return as that of direct issuers, but afforded less flexibility since the amounts, rates and maturities were fixed in advance whereas direct issuers could negotiate by telephone concerning these matters in order to meet the Fund's needs on a given date.

By the Fall of 1969 the rate differential, or rate of return spread, between dealer and direct paper had widened and the volume of paper and the variety of issuers offered by dealers increased to the point where the Fund's specific needs could be met. Arthur M. Kesselhaut, the Fund's Treasurer, brought this to the attention of John Haire, President of Anchor and of the Fund, and suggested that some dealer-placed commercial paper be purchased for the Fund. Haire approved the making of purchases from dealers, provided that certain guidelines were adhered to, similar to those followed in connection with purchases made directly from issuers. These were principally that the paper should bear a National Credit Office rating of "prime", no more than 10% of the outstanding paper of any issuer should be purchased, and the dealer should agree to repurchase the paper at the Fund's request. Kesselhaut discussed these requirements with representatives of Goldman, Sachs & Co., Lehman Commercial Paper Incorporated and A. G. Becker & Co. Incorporated, large dealers in commercial paper. In addition to the requirements stated above, he also insisted that the issuer be listed on a national securities exchange.

In the course of his discussions with Goldman, Sachs & Co., Kesselhaut was told that "each company they [Goldman, Sachs] represented was analyzed by a credit man at Goldman and that they had current financial information on every company they represented", the implication to him being that they "knew as much about the company as could be known". Kesselhaut understood that the two other dealers likewise made a current credit analysis of the companies whose paper they offered.

Several weeks after the Fund had begun to purchase paper from dealers, a representative of Goldman, Sachs & Co. called and offered Arthur Burach, Kesselhaut's assistant, \$20 million of commercial paper of each of Penn Central and Chrysler Corporation, yielding 9% for 270 days (the maximum maturity of such paper). Kesselhaut was interested in the offer since he believed that interest rates had turned downward and would continue to fall, and he saw an opportunity to obtain a favorable rate of interest for a maximum period.

The approval of one of the three Fund managers was normally required in connection with each purchase of commercial paper, but because of the size and duration of the proposed purchase a conference was held, attended by Robert Daniel (chairman of Anchor's Investment Committee), Kesselhaut, and all three of the Fund managers, Robert Baines, Ronald Welburn and Bryant Hanley.[3] The discussion dealt with the principle of a purchase of 270-day paper as well as the availability of the cash required, and the two purchases were approved from this point of view. However, since not all the cash was immediately available

[3] This is Kesselhaut's firm recollection. When interviewed, Baines and Welburn did not recall the meeting but acknowledged that they had either initialled approval of the purchase or had been told of the purchase shortly after it was made.

a schedule of purchases of Penn Central paper was adopted, with $5 million each to be purchased on four separate occasions at intervals of several days during the period November 28, 1969 to December 8, 1969. The $20,000,000 of Chrysler paper was likewise to be purchased in four equal $5,000,000 installments at about the same time. The financial condition of Penn Central was not discussed.

In making purchases of commercial paper from dealers, including the Penn Central paper, Kesselhaut believed that the Fund was sufficiently protected by (i) the "prime" rating given by the National Credit Office, one of the principal national rating organizations, (ii) the current credit analysis of each issuer which—based on representations by Goldman, Sachs & Co. and the other dealers—he believed was being performed by the dealer and formed the basis for the dealer's recommendation which he understood was implicit in its offer of the paper, (iii) the short-term nature of the investment, (iv) the fact that the issuer was a listed company whose name he recognized and the Fund managers were likely to also recognize, and (v) the likelihood that the Fund manager who approved the purchase would have alerted him to any seriously adverse information which he possessed about the issuer and which Kesselhaut himself might not have had. Because of this belief that the criteria established by Anchor provided sufficient protection—a belief buttressed by the financial community's general acceptance of commercial paper as a safe money-market instrument—Kesselhaut did not undertake, or have any other employee of Anchor perform, an independent analysis of the financial condition of issuers (including Penn Central) whose paper was offered to him by dealers, or any continuing review during the period in which the purchased paper was held by the Fund.

An article appeared in the May 18, 1970 issue of Barron's entitled "Beautiful Balloon? Rapid Growth of the Commercial Paper Market May Be Risky." The article did not mention Penn Central but expressed a general concern about the safety of commercial paper. Prompted by the article, the Fund sought to reduce the amount of its Penn Central and Chrysler commercial paper holdings by requesting Goldman, Sachs & Co. to repurchase half of both holdings, but Goldman, Sachs refused to repurchase the Penn Central paper.

As stated earlier, on June 21, 1970 a petition for reorganization of Penn Central was filed and its commercial paper was not paid at maturity.

The Action Against Goldman, Sachs & Co.

Late in 1970 the Fund and three other parties commenced a suit against Goldman, Sachs & Co. in which the Fund sought to recover its $20 million investment. The complaint alleged that, in connection with the sales of Penn Central commercial paper, Goldman, Sachs made numerous misstatements of material facts and omitted to state numerous material facts in violation of Section 12(2) and Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, Section 352-c of the General Business Law of the State of New York, and the common law. In July, 1974, the Fund with the approval of its full Board of Directors settled its suit against Goldman, Sachs, and received $5,250,000 in cash; although the Fund also retained a 73.75% interest in the commercial paper which will make it whole if the notes are paid, the likelihood of any additional amounts being recovered as a result of this settlement is, at the present time, uncertain.

The three other plaintiffs in the action pressed the case to trial, and on October 9, 1974 a jury verdict was rendered in their favor for $3,000,000—the amount of their loss—plus interest. The jury, in reaching this verdict, must of necessity have concluded that Goldman, Sachs & Co. had withheld from its customers material non-public information concerning Penn Central.

The Derivative Action

In February, 1973 a derivative action entitled *Lasker et al.* v. *Burks et al.* was commenced by two shareholders of the Fund in the United States District Court for the Southern District of New York against Anchor and all of the directors of the Fund who were in office when the Penn Central paper was purchased and held. The Fund is a nominal defendant in the suit.

The complaint alleges that the Fund's purchases of the Penn Central paper were made by Anchor and the Fund's directors in sole reliance upon Goldman, Sachs & Co., without an independent investigation of Penn Central's financial condition or the quality of its commercial paper, and that such an investigation would have revealed a number of material adverse facts concerning Penn Central. The failure to make such an investigation is alleged to constitute a failure by Anchor to meet its responsibilities as the Fund's adviser; and it is also alleged that the Fund directors knew (or should have known) of, and acquiesced, in Anchor's failure to meet its responsibilities.

The complaint further recites that Anchor and the Fund directors failed to conduct a continuous review of the financial condition of Penn Central subsequent to the purchase of the paper—which review would have revealed a number of other material adverse facts—and that they failed to make adequate attempts to resell the paper.

It is asserted that the foregoing conduct was in violation of (i) Section 36 of the Investment Company Act of 1940, (ii) Section 206 of the Investment Advisers Act of 1940, (iii) the defendants' common law fiduciary duty to the Fund, and (iv) the terms of the advisory contract between Anchor and the Fund.

Finally, the complaint alleges that, when the amount of Penn Central commercial paper outstanding fell far below the initial $200,000,000, the Fund's holdings became much more than 10%, thus violating the Fund's fundamental policy that it would not "hold" more than 10% of the "outstanding securities" of a single issuer. This is claimed to constitute a violation of Section 13(a)(3) of the Investment Company Act of 1940.

The *Lasker* suit had been stayed pending the resolution of the suit brought by the Fund against Goldman, Sachs & Co., and the defendants (including the Fund) have not yet filed their answers. With the settlement in the latter suit concluded, the plaintiffs in the derivative suit have indicated their intention to carry it forward.

Discussion of Law

The complaint in the derivative action sets forth what appear to be all of the possible grounds for asserting liability against Anchor and the Fund directors for the loss which the Fund incurred because of its purchase of the Penn Central commercial paper (the "Penn Central loss"). Accordingly, in considering whether such liability exists and if so what action you should take in order to enforce it, I shall treat the various claims contained in the complaint.

Section 36 of the Investment Company Act

It is my opinion that neither Anchor nor any Fund director is liable to the Fund under Section 36 of the Investment Company Act of 1940 for the Penn Central loss.

Section 36—as it read at the time of the Fund's purchase of the Penn Central paper and until after the Penn Central bankruptcy proceedings were begun—authorized the Securities and Exchange Commission to bring an action against an officer, director or investment adviser of a registered investment company for "gross misconduct or gross abuse of trust in respect of "the investment company. Although Section 36 expressly provides for actions to be brought by the Commission, the courts have held that private suits may likewise be brought under its provisions. *Brown* v. *Bullock*, 194 F. Supp. 207 (S.D.N.Y. 1961), *aff'd*, 294 F.2d 415 (2d Cir. 1961); *Moses* v. *Burgin*, 445 F.2d 369 (1st Cir. 1971).

It seems clear—from the legislative history of Section 36, from a 1970 amendment to that section, and from judicial interpretation—that the use of the language "gross misconduct or gross abuse of trust" was deliberate and was designed to cover the type of conduct it explicitly describes and not mere negligence. Initially, Section 36 was drafted so as to make the proscribed conduct a criminal act, and the word "gross"' was "added to insure that only the more serious kinds of abuse", not mere negligence, "would be subject to sanctions" and render a person guilty of a crime. See Eisenberg & Phillips, "Mutual Fund Litigation—New Frontiers for the Investment Company Act," 62 Columbia Law Review 73, 99. Although the criminal sanctions were removed from the draft bill and replaced by the provision for actions brought by the Commission, the language describing the prohibited conduct remained. In *Rosenfeld* v.

Black, 445 F.2d 1337 (2d Cir. 1971), although the court held that an investment adviser to a mutual fund violated a fiduciary duty when it realized profits in connection with the appointment of a new adviser upon its recommendation, the court did not predicate its decision on Section 36, saying of that provision (p. 1346):

> "Words and remedies such as these were clearly addressed to highly reprehensible conduct [citation omitted]; we would not dream of suggesting, much less holding, that [the adviser's] actions were so culpable."

Indeed, an amendment to Section 36, made in December 1970—about a year after Anchor had purchased the Penn Central paper and some six months after the petition for its reorganization had been filed—serves to point up the distinction between Section 36's earlier standard of "gross" misconduct or "gross" abuse of trust and mere "nonfeasance of duty" or the like. The amendment added a new subsection "(b)" dealing with a breach of fiduciary duty in connection with the adviser's compensation, and at the same time deleted, from what became subsection "(a)", the words "gross misconduct or gross abuse of trust" and authorized Commission action where there is "a breach of fiduciary duty involving personal misconduct". In explaining the change, the Senate Committee on Banking and Currency wrote (Part F, Senate Report No. 91-184 to Accompany S. 2224 at 36):

> "* * * your committee does not intend to limit the Commission under this section to situations where an actual intent to violate the law can be shown or to acts of affirmative misconduct. In appropriate cases,

> *nonfeasance of duty or abdication of responsibility* would constitute a breach of fiduciary duty involving personal misconduct." (emphasis supplied)

Under these circumstances I conclude that even if—contrary to the opinion expressed herein—Anchor were deemed to have breached an obligation to the Fund in relying to the extent it did on Goldman, Sachs and on the National Credit Office, there was clearly no "gross misconduct or gross abuse of trust" in connection with the purchase of the Penn Central paper or its retention. The conditions adopted by Anchor for the purchase of dealer paper were believed by it to constitute a sufficient safeguard and, in reaching that conclusion, Anchor clearly acted reasonably and in good faith. Accordingly, in my opinion there is no liability under Section 36 on the part of Anchor or the directors of the Fund.

Section 206 of the Investment Advisers Act

It is also my opinion that neither Anchor nor any Fund director is liable under Section 206 of the Investment Advisers Act of 1940 for the Penn Central loss.

Section 206 is the anti-fraud section of that statute, corresponding with Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Section 206 reads, in pertinent part, as follows:

> "It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
>
> * * *
>
> (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. . . ."

Section 206, like Section 17(a) and 10(b), does not expressly provide for civil liability. The courts have held that Sections 17(a) and 10(b) do give rise to civil liability, and very recently the District Court for the Southern District of New York expressly decided that Section 206 likewise confers a private right of action. *Bolger* v. *Laventhol, Krekstein, Horwath & Horwath*, CCH Fed. Sec. L. Rep. ¶ 94,618 (S.D.N.Y. 1974).[4]

The leading case under Section 206 of the Investment Advisers Act is *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), in which the Supreme Court held that the SEC could obtain an injunction requiring an investment adviser to disclose its practice of purchasing a security shortly before recommending a purchase to its clients for long-term investment and then selling at a profit immediately after the rise in price caused by the clients' purchases. The Court held that the absence of misrepresentations and an intent to injure was immaterial in an injunctive action by the Commission, but acknowledged that it "is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for

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[4] It should be noted that there are two recent decisions in other districts to the contrary.

monetary damages." 375 U.S. at 193. This distinction between the elements required in an injunctive suit and a damage action is also present in suits arising under Section 10(b).

My research has discovered no case which considers whether some form of fraudulent intent is essential to establish a private right of action under Section 206. In the absence of relevant authority under Section 206, it is likely that the courts would look to the analogous provisions of Section 10(b). The rule in the Second Circuit has long been that some element of scienter (i.e., knowledge or wilfulness) is essential in suits brought under Section 10(b), see *Fischman* v. *Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951), and the rule continues to be that "mere negligence is insufficient." *Leasco Corporation* v. *Taussig*, 473 F.2d 777, 785 (2d Cir. 1972); *Shemtob* v. *Shearson, Hammill & Co.*, 448 F.2d 442 (2d Cir. 1971). Moreover, the District Court for the Southern District in *Jones Memorial Trust* v. *Tsai Investment Services, Inc.*, 367 F. Supp. 491 (1973), recently considered Section 206 in a case in which the plaintiff sought damages for the diminution in value of its investment portfolio, claiming that the investment adviser had mismanaged "the process of researching and recommending investment transactions." The Court found no credible evidence of such mismanagement, stating in the course of its opinion (at 497):

> "The plain words of Section 206 of the Investment Advisers Act of 1940 make no mention of mismanagement, but speak solely and exclusively to concealment and misrepresentation."

In my opinion the element of fraudulent intent is necessary to establish a private cause of action under Section

206. Consequently, since for the reasons stated in my discussion of Section 36, there is a total absence of any such intent, it follows that there is no liability under Section 206 on the part of Anchor or the Fund directors.

Common Law Liability of Anchor for the Purchase

Concededly, Anchor did not make its own independent investigation of the financial condition of the issuers whose commercial paper was offered to it by selected dealers. It did, however, adopt a number of safeguards which it believed provided sufficient protection, particularly with respect to short-term money market instruments which had general acceptance in the financial community: (1) the paper had to be rated "prime" by National Credit Office, one of the principal rating organizations in the country, which presumably made an appropriate credit investigation; (2) the paper had to be recommended by a nationally known and respected investment banking firm, which had represented that it performed its own credit analysis of the issuer; and (3) the name of the issuer had to be recognized by the Fund Treasurer, and presumably by the Fund manager who also approved the purchase—the presumption being that, if either knew of any reason not to purchase the issuer's paper, he would so indicate. The Penn Central paper met these conditions; in connection with item (3) above, it should be noted that Penn Central was undoubtedly regarded generally as a mainstay of the nation's transportation system, and that its viability appeared unquestioned.

It is my opinion that, in purchasing the Penn Central paper under these circumstances, Anchor acted in good faith and in what should be regarded as a reasonable and prudent

manner. Accordingly, if the rule applicable to investment advisers is the same as that applicable to corporate directors (who must act "in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like position"),[5] or as the rule applicable in general to trustees (who must use "such care and skill as a man of ordinary prudence would exercise in dealing with his own property"),[6] I believe it is clear that Anchor is not liable for the Penn Central loss on account of its purchase of the paper.

Because this rule refers to "ordinarily" prudent men or to men of "ordinary" prudence, it may be argued that it is inadequate in the case of an investment adviser which holds itself out as possessing special skills and competence. The rule generally applicable to persons who hold themselves out in this manner is that they must act with "the skill and knowledge normally possessed by members of [their] profession or trade";[7] similarly, if a trustee procures his appointment as trustee by representing that he has greater skill than that of a man of ordinary prudence, "he is under a duty to exercise such skill."[8] This is the rule which I believe should apply to the present case.

I have found no authority, however, which attempts to spell out precisely what this means in the case of an investment adviser.[9] In my opinion the test is one of reasonable-

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[5] See, e.g., N.Y. Business Corporation Law, § 717, N.J. Business Corporation Act § 14A:6-14.

[6] See, Restatement, Second, Trusts § 174.

[7] See, Restatement, Second, Torts § 299A.

[8] See, Restatement, Second, Trusts § 174.

[9] Indeed, in *Jones Memorial Trust* v. *Tsai Investment Services, Inc.*, 367 F. Supp. 491 (S.D.N.Y. 1973) the court stated that there was no evidence whatever produced at the trial as to what the standard of care is for a properly managed investment advisory service.

ness and prudence under the circumstances, and it is also my opinion that Anchor met that test, unless—~~which~~ appears unlikely—there can be developed substantial evidence that, in 1969, no investment adviser would or did rely in the purchase of commercial paper on the combination of factors relied on by Anchor.

In this connection it is noteworthy that among the purchasers of Penn Central paper after Anchor's purchases were American Express Company, California Institute of the Arts, Carnegie-Mellon University, Franklin Savings Bank, Getty Oil Corp., Marine Midland Bank, United States Trust Company of New York and University of Southern California.

I must point out, however, that in the absence of any authority, the contention can be made—as it is in the complaint in the derivative action—that since an investment adviser maintains an organization trained in financial analysis and performs such analysis of a very large number of companies, and since it is paid for investment management which presumably is based on this analysis, such an adviser should, as a matter of law, be held to a duty to make its own investigation and analysis, as well as its own independent decision based thereon for every purchase, not only of longer-term investments but also of short-term money market instruments such as commercial paper.

In support of such a contention it could be pointed out that an investment adviser is for some purposes a fiduciary, and that as a general rule a trustee (i.e., a fiduciary) must not rely on a third party to select investments (Restatement, Second, Trusts, § 171). I turn now to this argument.

The rule as set forth by § 171 of the Restatement of Trusts is as follows:

> "The trustee is under a duty to the beneficiary not to delegate to others the doing of acts which the

trustee can reasonably be required personally to perform."

This is amplified by Comment h, which states:

> "A trustee cannot properly delegate to another power to select investments."

The cases in which this rule has been invoked to hold a trustee liable have involved a virtually complete delegation of the trustee's powers and functions. For example, in *Meck* v. *Behrens*, 252 P.91 (Wash. 1927), the trustees had by contract turned over to a corporation the entire administration of the trust property, and In *re Shintaffer's Estate*, 4 P. 2d 764 (Kans. 1931) an executor had authorized another individual to make investments without any supervision by the executor.

I have found no case which holds that a trustee may not decide to make—or retain—an investment based upon the recommendation of a qualified professional, under circumstances such as those in which Anchor acted. On the contrary, in *In re Kohler's Estate*, 33 A.2d 920 (Pa. 1943), the court refused to surcharge an executrix who had entered into an agency agreement with a trust company which was to make such investments as she should authorize and was to suggest suitable investments. The court held that since the executrix maintained constant contact with the agent, knew of the transactions, and approved them there had been no improper delegation; it stated that if full power to manage and invest had been turned over, the executrix would have been liable for any loss. Compare *In re Estate of Quinlan*, 273 A.2d 340, 342 (Pa. 1971), where the court stated that the executor had "permitted the Bank to exercise on his behalf practically all of the duties and functions of an executor" and held that "this delegation is, of course, improper."

Accordingly, it is my opinion that there was no improper delegation by Anchor within the meaning of the above-described rule.

Moreover, if the "no delegation" rule is intended to apply to trustees a rigid test which goes beyond that of reasonableness and prudence under the circumstances, and to impose liability without regard to good faith and the reasonableness of the action actually taken, it is my belief that it should not be extended to apply to investment advisers, who certainly are not trustees in the strict sense.

It is true that some Courts have referred to an investment adviser as a "fiduciary", but this has been in the context of a holding that the adviser must, like a fiduciary, avoid conflicts of interest and must act in good faith (*Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191, 194 (1963)), or that the adviser may not profit from the sale of his office (*Rosenfeld* v. *Black*, 445 F.2d 1337 (2d Cir., 1971)). This, of course, does not mean that an investment adviser is a fiduciary for *all* purposes, and I know of no case which so holds. Indeed, that the use of the term "fiduciary" is not dispositive is clearly indicated in *Rosenfeld* v. *Black*, *supra*, where the court said (445 F.2d at 1343):

> "While 'to say that a man is a fiduciary only begins analysis' . . . we would see no reason why the 'well-established principle of equity' forbidding realization of profit for effecting the turn-over of *corporate or other fiduciary office* should not apply to the investment adviser of a mutual fund." (emphasis supplied)

Since, then, I am of the view that reasonableness and prudence under the existing circumstances is the appropri-

ate test, and that any rule which goes beyond such a test and imposes liability without regard to good faith and the reasonableness of the action taken should not be extended beyond the areas to which existing authority applies it, I conclude that this aspect of the trustee rule should not be applied to investment advisers.

As already noted, however, the absence of authority could permit a court to take a contrary view, to apply the strict rule to investment advisers, and hold that Anchor's actions in purchasing the Penn Central paper were in contravention of the rule and accordingly subjected Anchor to liability for the Penn Central loss.

It would also be possible for a court to adopt a somewhat less stringent view and hold that since Anchor did not make its own investigation, it is bound by what such an investigation would have shown, so that the reasonableness and prudence of the purchase of Penn Central paper must be determined by a jury—or the court as the trier of fact—on the basis of the facts which would have been learned by the investigation. Obviously, one cannot predict what a jury, or a court, will find on the facts, particularly with the benefit of hindsight. In view, however, of the identity of other purchasers of the paper at that time (and indeed at much later dates), it is not a foregone conclusion that the finding would be that the Penn Central paper should not have been purchased.

Common Law Liability of Anchor for Retention

Since, in my opinion, Anchor is not liable because of the purchase of the Penn Central paper, it becomes necessary to consider those allegations of the complaint in the derivative action which charge that in the period subsequent to the purchase of the Penn Central paper Anchor

did not commence an adequate investigation of, and keep under continuous review, the financial condition of Penn Central; that such an investigation and review would have revealed certain material adverse facts; and that Anchor failed to advise the Fund of the advisability of attempting to resell the paper.

The questions which these allegations raise are: (1) did Anchor's failure, under the circumstances, to make an independent investigation of Penn Central's financial condition after the purchase, and to maintain a continuous review thereafter, violate the standard of good faith, reasonableness and prudence enunciated above? (2) If so, would a reasonable and prudent adviser have concluded that an attempt to resell the paper should be made? (3) If so, when would such a conclusion have been reached, and would it have been possible at that time to resell the paper and, if so, how much could have been resold (i.e., to what extent was any inaction by Anchor the cause of the loss)?

These questions arise only if (as I believe should be the case) Anchor is found not liable for the purchase, i.e., only if Anchor is found to have acted reasonably and prudently in purchasing the paper. In this context, it is my opinion that it did not breach any duty to the Fund in not conducting a subsequent investigation or review.

If the initial purchase did not give rise to liability on Anchor's part because Anchor acted reasonably and prudently in relying on the combination of factors already described—including the current credit analysis which it believed Goldman, Sachs had made and the short-term maturity of the paper—I believe it was equally reasonable and prudent for Anchor to rely on those same factors in retaining the paper. A "prime" rating by the National Credit Office and a recommendation based upon a current

analysis by Goldman, Sachs, which must have been made in the light of the maturity of the paper being offered, could have no meaning except that such short-term paper could safely be purchased *and held to maturity*. Furthermore, Goldman, Sachs was continuing to offer and sell substantial amounts of Penn Central paper during the first quarter of 1970, thus apparently indicating its own belief, presumably based upon continuing analysis, that such paper was safe.

Here, again, there is no available authority. It is, therefore, possible that a court could hold that, despite the absence of liability for the initial purchase, and particularly in view of the fact that the Penn Central paper had the maximum permissible maturity for commercial paper—namely 270 days—a reasonable and prudent investment adviser should have conducted its own review, or at least assured itself that Goldman, Sachs was in fact conducting a continuing review and found no cause for changing its favorable recommendation.

If a court were so to hold it would have to consider questions (2) and (3), above (p. 27). Likewise, if the court were to adopt the less stringent rule described above (p. 26), and hold that as a matter of law Anchor was required to make its own initial investigation and—although not automatically liable for failure to do so—is liable if such an investigation should have led it to refrain from making the purchase, the court could also determine that Anchor was required to conduct a continuing review and would have to consider the same two questions.

These questions would be questions of fact, to be decided by the trier of fact, be it court or jury. It is, of course, impossible for one to predict what such a trier of fact will find, particularly in complex circumstances. It must be noted,

however, that the complaint in the derivative action alleges [¶ 28(f)] that after April 22, 1970 it had become "virtually impossible for Goldman, Sachs to resell Penn Central commercial paper as it became due." Thus, although the period during which the complaint alleges that a review should have been continued was November 28, 1969 to June 21, 1970—the date of the reorganization petition—we are in fact dealing with a period ending no later than April 22, 1970, for it appears that whatever adverse information could have been ascertained thereafter could not have affected the result for the Fund.

The principal adverse information which investigation or review during this period would have disclosed seems clearly to be the substantial loss incurred for the first quarter of 1970, ended March 31, 1970. The report of this loss was released on April 21 but was not printed in the Wall Street Journal until April 23, 1970. Had Anchor determined at that time, because of the loss, to attempt to resell the Fund's Penn Central paper, it appears likely that it would not have been able to do so.

These circumstances, in my judgment, reduce the likelihood that the trier of fact will find that, had Anchor conducted its own review, it would have determined to resell the Penn Central paper at a time when this could have been done. Without such a finding, Anchor would not be liable for its failure to conduct a review.

Contractual Liability of Anchor

The Agreement for Investment Supervisory and Corporate Administrative Services between the Fund and Anchor, dated August 22, 1969, and in effect until May 1, 1970,

contains the following provisions relating to Anchor's obligations to furnish investment advice and supervision:

> "FIRST: Anchor shall supervise the investment operations of the Fund and the composition of its portfolio, and, to the extent reasonably required in the conduct of the business of the Fund, Anchor shall furnish to the Fund from time to time advice and recommendations with respect to investments, investment policies, the purchase and sale of securities and the management of its resources. In the performance of this function, Anchor shall also from time to time furnish to the Fund such reports and information relating to industries, businesses, securities, monetary and other economic factors and conditions, and such other information and advice, as may be reasonably required by the Fund or as Anchor may deem to be helpful to the Fund."

> "SECOND: * * * "

> "THIRD: Anchor agrees to use its best efforts in the furnishing of investment supervisory and corporate administrative services hereunder, and shall at all times maintain a staff of officers and other trained personnel for the purpose of performing its obligations under this agreement. Anchor may, at its expense, employ other persons to furnish administrative services to the Fund or to furnish to Anchor statistical and other factual information, advice regarding economic factors and trends, information with regard to technical and scientific developments, and such other information and assistance as Anchor may desire."

In my opinion nothing in these provisions imposes on Anchor the duty to make its own independent investigation of the financial condition of Penn Central prior to its purchase of the Penn Central paper or while the Fund held such paper. On the contrary, I believe they impose on Anchor the duty to act in good faith, with the degree of skill and knowledge normally possessed by investment advisers. That the test is one of reasonableness under the circumstances is attested by the phrase "reasonably required" used twice in paragraph FIRST. And of equal importance, paragraph THIRD explicitly authorizes Anchor to employ persons not on its own staff to furnish factual information, advice concerning economic factors and trends, "and such other information and assistance as Anchor may desire"; this provision seems clearly to permit Anchor to rely on such information and assistance if it was reasonably prudent in selecting the person who rendered it.

For these reasons and the additional reasons discussed in connection with Anchor's common-law liability, it is my opinion that the Agreement does not impose upon Anchor any liability for the Penn Central loss.

Common-law Liability of the Fund Directors

The Fund is a Delaware corporation, and the duties and liabilities of its directors are therefore governed by Delaware law. Under Delaware law, as stated in *Graham v. Allis-Chalmers Manufacturing Company,* 188 A.2d 125, 130 (Del. 1963),

> ". . . directors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances. Their duties are those

> of control, and whether or not by neglect they have made themselves liable for failure to exercise proper control depends on the circumstances and facts of the particular case.
>
> * * *
>
> ". . . If he has *recklessly* reposed confidence in an obviously untrustworthy employee, has refused or neglected *cavalierly* to perform his duty as a director, or has ignored either *willfully* or through *inattention* obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him." (emphasis supplied)

The rule stated in the *Graham* case applies to the directors of both a mutual fund corporation and an ordinary Delaware corporation. See *Lutz* v. *Boas*, 171 A.2d 381, 395 (Del. Ch. 1961).

The Delaware rule is similar to the statutory rule in New York and New Jersey, where a director is required to act "in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions." N.Y. Business Corporation Law, § 717; N.J. Business Corporation Act, § 14A:6-14.

While in theory the investment adviser of a mutual fund merely makes recommendations to the fund, which, acting through its officers and under the supervision of its directors, makes the actual decisions, in practice it is abundantly clear that all decisions on the purchase and sale of specific securities are necessarily made by the adviser, whose employees serve also as the officers and employees of the fund, and that the Board of Directors of the fund is necessarily limited to the "control" function referred to in the *Graham* case, above, that is, the review of

and decisions on the basic investment policies, and general supervision of the procedures and performance of the adviser. This is substantially the same as the function of the Board of any ordinary business corporation, which could not and would not decide on the types of raw materials or machinery which the corporation purchases or the details of the design, production and marketing of its products, but rather is responsible for the selection, and review of the performance, of the management and for basic corporate policy. Clearly, under the rules stated above, a Board of Directors would not be held liable for losses caused by management actions taken in good faith and judged as reasonable under the circumstances. Similarly, the directors would not be held liable even for management actions which are subsequently viewed as negligent, provided the Board had no reason to suspect that management was not acting properly, and was not, and in the exercise of normal prudence could not be, aware in advance of the action to be taken.

Since it is my opinion that Anchor did not violate any duty to the Fund either in the purchase or in the retention of the Penn Central paper, it follows that the Fund directors violated no duty in connection therewith and, therefore, have no liability for the Penn Central loss.

Even if it were held that Anchor had a duty to make an independent investigation or review of Penn Central's financial condition, it is my opinion that under the principles of law applicable to directors, the Fund's directors would not be liable for the Penn Central loss. In the purchase of commercial paper for the Fund, Anchor had for about four years bought directly from the eight issuers on its approved list, and had commenced purchasing from dealers only shortly before the purchase of the Penn Cen-

tral paper. There is no evidence that the Fund directors knew before the Penn Central purchase either that (i) a change in procedure had been made and that some dealer paper was being purchased or (ii) that Anchor was not making an independent investigation of the companies whose paper was being bought from dealers; furthermore, there is no clear evidence that it knew thereafter. According to the minutes of a Board meeting held on December 17, 1969, the purchase of commercial paper was discussed, but the nature of the discussion is not indicated. Kesselhaut thinks that he explained that dealer paper was being purchased, and may have discussed the procedure for purchasing dealer paper, but he is not certain, and Haire had no recollection on the subject. Under these circumstances it is an issue for the trier of fact to ascertain whether the Board knew, or should have known, even some time after the Penn Central purchases, that dealer paper was being purchased without an investigation and analysis by Anchor.

Furthermore, even if the Fund directors did know or should have known, it is my opinion that they did not violate their duties as directors by not requiring Anchor to undertake an immediate investigation or to attempt to resell the Penn Central paper. Since I believe that Anchor itself acted reasonably and prudently in purchasing and holding the Penn Central paper in reliance on the factors discussed above, and since there is no existing authority indicating that Anchor was required to make its own investigation and analysis, I believe the Fund directors would clearly have been warranted in accepting this procedure and I do not believe they could be found to have been negligent in doing so.

Section 13(a)(3) of the Investment Company Act of 1940

Section 13(a)(3) of the Investment Company Act of 1940 in part prohibits an investment company from deviating, without shareholder approval, from any policy it has deemed to be fundamental in its registration statement.

I understand that the original registration statement filed by the Fund stated as a fundamental policy that it would not "purchase" more than 10% of the securities of any one issuer. I have been informed that the registration statement has been amended on numerous occasions and that the precise content of the registration statement during 1969-1970 is not readily determinable. The original source of the 10% limitation was apparently a by-law provision which has since been replaced by a provision in the Fund's certificate of incorporation stating that the Fund may not "acquire or hold more than ten percent (10%) of the outstanding securities of any one issuer". Since it is likely that the registration statement is no more permissive than the Fund's charter document, I think it appropriate to assume that fundamental policy prohibits the retention, as well as the acquisition, of more than 10% of an issuer's securities. This is consistent with the Fund's prospectus (as revised September 2, 1969). It is clear that the application of the restriction is not limited to voting securities.

In my opinion this fundamental policy did not prohibit Anchor from continuing to hold $20,000,000 of Penn Central commercial paper at a time when the total amount of outstanding Penn Central commercial paper fell below $200,000,000. The restriction is expressed in terms of the "securities" of the issuer, not in terms of any "class of securities."

The issue is simply whether $20,000,000 of commercial paper constituted more than 10% of Penn Central's "secu-

rities". I believe that it manifestly did not. Commercial paper accounted for only a small fraction of Penn Central's securities. As of December 31, 1969, Penn Central's balance sheet showed debt securities of over $1,793,000,000; even if secured debt is excluded, total short-term debt and unsecured bank borrowings were $500,000,000. These were, in my opinion, part of Penn Central's "securities," so that the Fund's holdings of commercial paper did not approach 10%.

Alternative Courses of Action

With the Fund's claim against Goldman, Sachs & Co. settled, the Fund must now determine the position which it will take in the *Lasker* derivative suit. In the present posture of that suit the Fund has three alternative courses of action:

1. As the party in whose interest the suit has been commenced, the Fund might seek realignment so as to become a plaintiff for the purpose of exercising control over and prosecuting the action.

2. The Fund might take the position that the action is sufficiently lacking in merit that it should not be prosecuted and should therefore be dismissed.

3. The Fund might take a neutral position, permitting the action to proceed for its benefit under the auspices of the present plaintiffs.

The first alternative would involve legal expense to the Fund, likely to be substantial, in pursuing a claim which, in my opinion expressed herein, should not be sustained.

Further, it would probably require the Fund to terminate its advisory agreement with Anchor, since it might have a prejudicial effect upon a court or jury if the Fund were vigorously prosecuting a suit against Anchor while at the same time retaining it as adviser.

If the second alternative were adopted and the Fund were actively to seek dismissal of the suit, current court procedures would appear to require a hearing substantially on the merits. The cost to the Fund of such a proceeding, in which it would be seeking to defeat a very large claim on its behalf brought by its stockholders, might be substantial. Furthermore, to the extent that the Fund directors who are defendants in this suit were to incur legal expenses for their own counsel in connection with the proceedings, the Fund might be liable to indemnify such directors for these expenses to the extent not covered by an indemnity policy.

If the third alternative were adopted and the suit permitted to proceed without active participation by the Fund, the Fund might again be liable to indemnify its directors for their legal costs, unless they were held liable to the Fund for the Penn Central loss. This alternative would leave to the court the final determination of the difficult questions of fact and law involved, while retaining the possibility of a substantial recovery for the Fund.

It is for the Board of Directors of the Fund to determine, in the exercise of its discretion and business judgment, which alternative to adopt.

Very truly yours,

s/ Stanley H. F‑ld

Exhibit C to Affidavit of Leon T. Kendall sworn to January 23, 1975—Supplemental Report of Stanley H. Fuld to Board of Directors of Fundamental Investors, Inc. dated December 18, 1974

(Letterhead of)

STANLEY H. FULD
425 Park Avenue
New York, N.Y. 10022

December 18, 1974

PRIVILEGED AND CONFIDENTIAL
Board of Directors
of Fundamental Investors, Inc.
Westminster at Parker
Elizabeth, New Jersey

Dear Sirs:

This letter is intended to supplement my opinion, dated December 5, 1974.

First, I have been asked whether Goldman, Sachs & Co. agreed to repurchase all commercial paper which it sold to the Fund (including the Penn Central paper); if so, whether this was a legal and binding agreement and, if it was, why prompt legal action was not taken against Goldman, Sachs, based on the agreement.

As I pointed out in the opinion letter, Anchor required all issuers, from whom the Fund purchased commercial paper directly, to agree to repurchase it on demand, in order to provide liquidity—in order, in other words, to enable the Fund to convert paper into cash prior to maturity if the cash were unexpectedly needed. Clearly, a repurchase agreement *by the issuer* was not regarded as a guaranty, or safety factor, against bankruptcy of the issuer.

I believe that Mr. Haire's establishment of a repurchase agreement as a condition of the purchase of dealer paper had the same purpose, and he and Mr. Kesselhaut have, in

fact, stated that they looked upon it as a liquidity device rather than as a guaranty against loss. Indeed, it seems unlikely that they could have regarded the agreement as a guaranty against loss or as anything other than an undertaking to attempt to resell the paper to the issuer or others if the Fund so wished.

Accordingly, it appears clear that there was not—and that Anchor did not believe there was—any legal, binding agreement by Goldman, Sachs to repurchase the Penn Central paper. That being so, the Fund was warranted in not basing its suit against Goldman, Sachs upon such an agreement. I would merely add that, when Goldman, Sachs declined to repurchase the paper, it appears that Anchor sought unsuccessfully to have it repurchased by Penn Central, and that by then there had ceased to be any market for Penn Central paper.

Second, I have been asked to discuss more fully the rules relating to a possible position by the Fund's directors that prosecution of the derivative action is not in the Fund's best interests and that, consequently, the suit be dismissed.

The law is clear that the mere fact that a corporation has a supportable claim does not mean that the corporation must assert the claim in a lawsuit. As the Supreme Court (per Brandeis, J.) wrote in *United Copper Securities Co.* v. *Amalgamated Copper Co.*, 244 U.S. 261, 263 (1917), whether the corporation should "seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors. . . ." See, also, *Swanson* v. *Traer*, 249 F.2d 854 (7th Cir. 1957); *Ash* v. *International Business Machines, Inc.*, 353 F.2d 491 (3rd Cir. 1965); 13 Fletcher, Cyc. Corp., § 5822, p. 131. The same rule should, presumably, apply to a determination by the directors that an action commenced on behalf of the corporation by a stockholder should not proceed.

The law is not clear, however, on the extent to which a court will review the determination of the directors in such a case.

Language in some of the decisions indicates that the court should be concerned solely with the honesty and good faith of the Board's determination. Thus, in the *Ash* case, 353 F.2d 491, supra, the Court of Appeals for the Third Circuit declared (at 493):

> "The Supreme Court and, following it, the Courts of Appeals have repeatedly stated and applied the doctrine that a stockholder's derivative action, whether involving corporate refusal to bring anti-trust suits or some other controversial decision concerning the conduct of corporate affairs, can be maintained only if the stockholder shall allege and prove that the directors of the corporation are personally involved or interested in the alleged wrong-doing in a way calculated to impair their exercise of business judgment on behalf of the corporation, or that their refusal to sue reflects bad faith or breach of trust in some other way. [Cases cited.] Prevailing doctrine in the state courts is to the same effect.'

On the other hand, there are cases which suggest that more is required, that the directors must, as they are required to do generally, exercise ordinary prudence or diligence, that there must be some reasonable basis for the decision reached. For example, in *Levine* v. *Behn,* 174 Misc. 988 (Sup. Ct. N.Y. 1940), aff'd, 262 A.D. 729 (1941)—a case in which a derivative suit was brought against directors for paying rather than contesting a claim—the court wrote (174 Misc. at 991-2):

> "The test in each case, however, is the same, viz., whether or not the directors acted honestly and diligently and with a view to the promotion of the interests of the corporation. Of course, neither actual good faith nor advice of counsel will save directors if the facts afford no reasonable basis for a belief that a payment is for the best interests of the corporation. Honest belief without any basis in fact must be attributable to negligence."

And in *Perrine* v. *Pennroad Corporation,* 47 A. 2d 479 (Sup. Ct. Del. 1946)—a case involving the settlement of a lawsuit—the high court of Delaware declared (at 489):

> "Good faith may always be brought in question where it appears that the settlement of a dispute between stockholders of a corporation is so grossly inadequate that one is required to reach the decision that the directors were reckless and indifferent as to the rights of the stockholders and did not exercise reasonable business judgment."

In considering the subject before us, a word should be said of Rule 23.1 of the Federal Rules of Civil Procedure which provides, in part, that a derivative suit may not be "compromised" or "dismissed" without approval of the court. Although dismissal of the *Lasker* derivative action falls within the literal language of the Rule, it has been suggested that it does not apply to an involuntary dismissal. (Wright and Miller, 7A Federal Practice and Procedure, § 1839, p. 436.) However, since there are certain parallels between the two situations, I call your attention to the recent Second Circuit decision in *City of Detroit* v. *Grinnel Corporation,* 495 F.2d 448 (1974), which describes the court's role when approval of a settlement is sought (at 462):

> "When a District Court exercises its authority in approving a settlement offer, it must give compre-

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hensive consideration to all relevant factors and yet the settlement hearing must not be turned into a trial or a rehearsal of the trial. [Case cited.] The Court must eschew any rubber stamp approval in favor of an independent evaluation, yet, at the same time, it must stop short of the detailed and thorough investigation that it would undertake if it were actually trying the case."

If it were to appear to the Fund's nonaffiliated directors that the Fund's interests would be adversely affected by allowing the *Lasker* suit to continue to trial and decision and that it would be in the Fund's best interests to forego any possible recovery and have the suit dismissed, the directors could, of course, take those matters into account. And, if the directors were to conclude that reasons were presented which were persuasive and sufficient, they could then decide to seek dismissal. If this were done, the scope of review would be determined by the court in the light of the rules discussed above.

In short, it is my view that, at a minimum, the court would review the reasons for seeking dismissal and might consider, at least to some degree, the underlying merits of the derivative action. Whether reasons can be adduced, with supporting facts, sufficient to persuade the nonaffiliated directors to seek dismissal, and sufficient to persuade the court that a proper basis exists for the directors' action, must await a presentation to the directors.

Very truly yours,

s/ Stanley H. Fuld

Exhibit D to Affidavit of Leon T. Kendall sworn to January 23, 1975—Minutes of meeting of Board of Directors of Fundamental Investors, Inc. dated December 18, 1974

FUNDAMENTAL INVESTORS, INC.

Minutes of Meeting of Board of Directors

December 18, 1974

A special meeting of the Board of Directors of Fundamental Investors, Inc. was held on December 18, 1974 at the office of the Fund, Westminster at Parker, Elizabeth, New Jersey. The special meeting convened at 2:30 p.m. There were present:

Leon T. Kendall
Louis F. Laun
Mary S. O'Connor
Beryl Robichaud
William J. Stephens

constituting a quorum of the Board of Directors of the Fund for the special meeting. Mr. Leon T. Kendall was appointed by the Board of Directors as Chairman of the special meeting. The Board agreed on the procedure to be followed at the special meeting.

The following persons were invited to join the meeting at 3:10 p.m. for the purpose of responding to questions of the five directors: Hon. Stanley H. Fuld, Special Counsel to the Fund, John R. Haire, Chairman and Chief Executive Officer of Anchor Corporation, Donald M. Kemmerer and Charles F. Phillips, directors of the Fund, and Eugene P. Souther, Esq., counsel to the Fund.

Mr. Kendall presided and Mr. Souther acted as Secretary of the meeting.

The special meeting was held to consider further the Fund's holding of commercial paper of Penn Central Trans-

portation Company ("Penn Central") and also what further action, if any, the Fund should take with respect to the action entitled *Lasker, et al.* v. *Harry G. Burks, Jr., et al.* in the United States District Court for the Southern District of New York allegedly brought on behalf of the Fund by two individual shareholders of the Fund against Anchor Corporation and those directors who were members of the Board of Directors of the Fund at the time of the purchase of the Penn Central commercial paper.

Mr. Kendall called upon Special Counsel, former Chief Judge Fuld, who reported on the status of the *Lasker* action, described the claims made in that action and expressed his opinion as to the merits of each of those claims. Judge Fuld then discussed the alternatives available to the Board and the standards it should apply in deciding what course of action to pursue, stressing that Messrs. Kendall, Laun, Stephens and Mrs. O'Connor and Dr. Robichaud should act independently of the remaining members of the Board in deciding what in their business judgment exercised in good faith was in the best interests of the Fund.

Judge Fuld advised that the Fund had three alternatives:

1. Seek to realign itself as a party plaintiff in the action and take control of the prosecution of the action;

2. Instruct its counsel to seek to dismiss the action on the grounds that it was not in the best interests of the Fund to pursue it; or

3. Remain neutral in the role of a nominal party defendant and allow the action to proceed as directed by the shareholders who instituted the action.

Judge Fuld then summarized the analysis of the facts and law and the opinions as to the merits of the causes of action alleged in the complaint that he had set forth for the Board in his letters to the Board of December 5, 1974 and December 18, 1974.

Because he had concluded that there was no violation by Anchor or by the Fund directors of any provision of statute or of any common law or contractual obligation to the Fund, Judge Fuld advised against adopting the first alternative.

As to the second alternative, Judge Fuld counselled that the Board could conclude that there was no basis for the action and that its continuance would be damaging to the Fund. Such a decision would have to be made independently, in good faith and through the sound exercise of business judgment as to what action was in the best interest of the Fund. Should the Board conclude that it was not in the best interest of the Fund's shareholders or of the Fund for the action to continue, it could then instruct its counsel to move to dismiss the action.

The third alternative would leave the Fund in the role of a nominal party defendant taking no active part in the litigation but allowing the action to proceed against Anchor Corporation and the named directors of the Fund. In deciding whether to follow that course, Judge Fuld advised, among other things, that the Board could consider what effect the continued prosecution of the action could have on the Fund. There might result serious distraction of Anchor Corporation from its duties as adviser to the Fund caused by the preparation for and defense of the action. Anchor's ability to attract and retain qualified personnel under the circumstances might be affected. Any ultimate recovery might not be worth the serious impact

on the Fund of the prosecution of such an action to a conclusion.

The directors then questioned Judge Fuld at length concerning the facts and the law and his opinion as to the merits of the claims made and the chances of success on them. During that discussion Judge Fuld amplified on the contents of his letters to the Board.

The Chairman then called upon Mr. Souther, who discussed the practical implications of following each of the alternatives available to the Fund and the nature and extent of the proceedings each alternative would entail. Mr. Souther advised the Board that it could consider the possibility that as a result of retention by the Fund of a 73.75% interest in the notes under its settlement with Goldman, Sachs, the Fund might recover some additional amount in the reorganization of Penn Central. He also described the discovery proceedings and trial preparation that could be anticipated if the action were to continue and the type of work interruption that activity could entail, which might well have an adverse effect on the Fund's shareholders. Mr. Souther pointed out that there could be a substantial cost to the Fund for attorneys' fees for its counsel as well as for outside directors who were found not to be liable to the Fund. Finally, he told them that they could properly consider not only the chances of securing a substantial judgment against Anchor Corporation and possibly the director defendants, but also the practical possibility of collecting such a judgment. Mr. Souther reiterated that it was up to the five above-named members constituting the Board for the purpose of making this decision to act independently and in good faith and to exercise their sound business judgment in deciding which alternative to follow.

The Board then sought the views of Special Counsel and counsel as to whether the Fund's earlier decision to settle its case against Goldman, Sachs and the subsequent jury award for the full amount of their claim for plaintiffs in the *Welch* action against Goldman, Sachs compelled the Board to continue the *Lasker* action. Mr. Souther pointed out his understanding that the facts in the Fund's action against Goldman, Sachs and those in the *Welch* action were different in at least three significant respects: (1) plaintiffs in the *Welch* action had purchased the commercial paper sometime after the Fund's purchases, at a time when Goldman, Sachs knew even more about the serious financial condition of Penn Central; (2) the Fund might have been held to a higher standard of inquiry than plaintiffs in the *Welch* action on the theory that it was a sophisticated investor; and (3) amount of the Fund's claim against Goldman, Sachs ($20,000,000 plus interest) was so large that a jury might be reluctant to award such a judgment against Goldman, Sachs whereas the claim of the three plaintiffs together in the *Welch* action was only for $3,000,000 plus interest.

The Board then addressed a substantial number of questions to Mr. Haire concerning the procedure followed by Anchor Corporation in 1969 in purchasing commercial paper in general and of Penn Central in particular. In response to the questions of the Board, Mr. Haire discussed, among other things, his belief that at the time of purchase Goldman, Sachs had agreed to repurchase the paper at any time; that in the course of the action against Goldman, Sachs the Fund had learned that during the period from February 1, 1968 through June 21, 1970 Goldman, Sachs had repurchased commercial paper of various issuers some 1200 times, including approximately 40 re-

purchases of commercial paper of Penn Central up to May 1, 1970, and had repurchased from the Fund commercial paper of Chrysler Corporation and other issuers; that Anchor had established guidelines for the purchase of commercial paper as follows:

(a) that it be rated "prime" by the National Credit office;

(b) that not more than 10% of the outstanding commercial paper of any issuer should be purchased; and

(c) that the dealer should agree to repurchase the paper at the Fund's request.

Moreover, Goldman, Sachs had assured the Fund that it had made a thorough credit investigation of Penn Central.

It was not until the filing of the petition for reorganization by Penn Central that Goldman, Sachs asserted that it was not legally obligated to repurchase the commercial paper. Mr. Haire stated his belief that the guidelines had been followed in making the purchase and explained that he and those who had participated in the purchase had assumed, based on his understanding of the general practice, that Goldman, Sachs had an agreement with Penn Central which in turn had an agreement with its bankers that would insure that the paper would be bought back promptly at the request of the Fund.

The Board then inquired into the extent of the information made available to the Board at the time of the purchase of the Penn Central commercial paper. Mr. Phillips and Mr. Kemmerer participated in that discussion along with Mr. Haire. Mr. Haire explained that due to the short-term nature of commercial paper investments the specific

purchases were not identified in the monthly reports made to the Board, but instead all short-term investments were combined and identified as such. Information as to specific holdings at any time was available from the treasurer. In addition, a presentation with respect to commercial paper had been made to the Board on December 17, 1969.

Mr. Haire explained that it had been considered sufficiently prudent to include commercial paper under the description "short-term investments" because at that time commercial paper was considered to be the equivalent of cash (Judge Fuld read from the report of the staff of the Securities and Exchange Commission following its investigation of Penn Central which observed that the financial community at that time considered commercial paper to be the equivalent of cash) and because the investment in commercial paper normally was of such a short duration that it would not be picked up in a monthly report. Mr. Haire pointed out that the financial community at the time considered Penn Central—a company with assets of $7 billion—to be a sound investment as is shown by the number of sophisticated investors who purchased its commercial paper after the Fund's purchases. In response to questions, Mr. Haire stated that he believed that Anchor Corporation had followed procedures which were prudent in light of the prevailing view of the safety of commercial paper in general and of the soundness of the investment in Penn Central and that to his knowledge the normal procedure followed by other mutual funds was to lump short-term investments and not to identify them specifically in published reports.

The directors asked for an identification of those who had purchased Penn Central paper subsequent to the purchases by the Fund and those who still held that paper at the

time the reorganization petition was filed. Mr. Haire undertook to try to supply such information to the Board as soon as possible and gave the Board an interim list of the banks that had purchased Penn Central commercial paper after the Fund's purchases and a list, which he could not assure was complete, of the holders of Penn Central commercial paper as of June 21, 1970, the day the reorganization petition was filed. Copies of those lists were annexed to the minutes of this meeting.

In response to questions, Mr. Haire reported that it was not unusual in 1969 for mutual funds to invest in commercial paper and that the Penn Central investment had been attractive to the Fund's advisers in the fall of 1969 because of an anticipated fall off in interest rates, which did occur, which made it appear advantageous to secure an investment paying an interest rate as high as 9%.

In response to questions, Mr. Haire reported that on learning in the latter part of May of an article in *Barron's* expressing some concern about the safety of commercial paper, the Fund had asked Goldman, Sachs to repurchase $10 million of the commercial paper. Goldman, Sachs did not refuse, but, in effect, put off the repurchase with the assurance that it was processing the request. Thereafter, Goldman, Sachs suggested that the Fund ask Penn Central to repurchase the commercial paper. Again, instead of outright refusal the Fund was met with what in effect was a delaying tactic. Goldman, Sachs finally refused to repurchase the Penn Central commercial paper.

The Board then discussed the standard to be applied to Anchor Corporation in determining the degree of care it should have exercised. Judge Fuld referred to the discussion of that subject contained in his letter of December 5 and expressed his opinion that even if Anchor Corporation

were to be held to a higher standard as a sophisticated investor, he believed that it met that standard by establishing and following its guidelines. Mr. Haire added that in addition to relying on Goldman, Sachs, those charged with making investment decisions had considered the purchase, they knew Penn Central since it was a recent equity holding of the Fund, and they raised no objection to the purchase of the Penn Central commercial paper.

Mr. Kemmerer and Mr. Phillips were excused from the meeting at this point.

The Board then discussed the question of the impact on Anchor Corporation and on the Fund's shareholders of the *Lasker* action being pursued either by the Fund or by the shareholders who brought the action. The price paid for the notes was slightly more than $18.5 million. Considering the cash settlement received from Goldman, Sachs and ignoring any possible recovery on the Fund's remaining 73.75% interest in notes, a judgment, if obtained, could possibly amount to $15 million. There being approximately 100 million Fund shares outstanding, if there were a recovery of a judgment of $15 million it could result in a recovery of no more than 15¢ per share; however, the extent of such recovery would be diminished by the fees payable out of that recovery to attorneys for plaintiffs in the *Lasker* action, fees for counsel for the Fund and, possibly, fees for counsel for Fund directors found not to be liable to the Fund. It was estimated that the attorneys for plaintiffs in the *Lasker* action, if successful, might ask the court to award them fees ranging from 15-30% of the judgment.

Concerning conduct of the action should it continue, Mr. Haire explained that regardless of the lack of merit of the action and of his belief that there was slight chance of success by plaintiffs, Anchor would, of course, be required to

defend the action to the fullest, which would necessarily present substantial distraction to Anchor. In addition, he questioned the ability of Anchor to attract and retain the highly qualified personnel they want and need if such an action were being pursued with the acquiescence, if not under the control, of the Fund.

The Board then considered the question whether, if there were a judgment for the full amount, it could be collected. Mr. Haire reported that Anchor Corporation's current net worth is approximately $12 million, a sum less than the amount of a possible judgment. Washington National Corporation, of which Anchor Corporation is a wholly-owned subsidiary, is not a party to the action and Mr. Haire cou'd not represent to the Board whether Washington National Corporation would assist Anchor Corporation in making up any differential should a judgment be entered larger than Anchor Corporation was able at that time to pay. In response to a question, Mr. Haire reported that Anchor Corporation's gross management fees in 1974 were expected to be $4.1 million and were estimated to be $3.8 million in 1975.

Mr. Haire was then excused from the meeting.

The Board then conducted further discussion with Special Counsel and reviewed the subjects which had been discussed earlier. Judge Fuld reiterated the criteria to be followed by the Board in reaching its conclusion and advised that in assessing the decision to be taken by the Board a court would consider its independence, its honesty and its good faith in reaching whatever business judgment it reached.

The Chairman then excused Special Counsel and counsel who left the meeting and the Board continued its discussions.

The Board members in executive session expressed a desire to review again the various documents pertaining to the situation and agreed to communicate to the Chairman any further questions or points of information desired. It was agreed that the Chairman would contact each member individually as to the next step for the committee to take.

The Board adjourned at approximately 6:00 p.m.

s/ Eugene P. Souther
Secretary

s/ Leon T. Kendall
Chairman

ATTACHMENTS TO MINUTES OF DECEMBER 18, 1974

BANKS

Manufacturers Hanover Trust
First National Bank
State Street Bank and Trust
National Bank of Wyandotte
National Sawmut Bank
Mellon National Bank and Trust Co.
Chemical Bank
Fairfield National Bank
Central National Bank and Trust
Security National Bank
Bank of Lyons
First National Bank of Tulsa
Fort Wayne National Bank
Bankers Trust Co.
City National Bank
Citizens Bank
Brown Bros. Harriman & Co.
Seattle First National Bank
First National Bank of Atlanta
Provident National Bank
Peoples Bank and Trust Co.
Security Pacific National Bank
First National Bank of Boston
Fort Worth National
Valley Bank and Trust Co.
Amoskeag National Bank
First National Bank of Elkhart
Northern Trust Co. of Chicago
First National Bank of Chicago
First and Merchants National Bank
National Boulevard Bank
Louisiana Bank and Trust Co.
The Fidelity Bank
Detroit Bank and Trust Co.
Marine Midland Grace Trust Co.
Worcester County National Bank
Wells Fargo Bank
First National Bank of Orlando
State National Bank
Philadelphia National Bank
Des Plaines Trust & Savings Bank of Chicago
United California Bank
Calumet National Bank
Webster Groves Trust Co.
First Security National Bank and Trust
Third National Bank of Hampden
First Wisconsin National Bank
American National Bank and Trust
National Bank of North America
Wachovia Bank and Trust Co.
Equitable Trust Co.
U. S. Trust Company
Bank of New York
Farmers Savings Bank
City Bank and Trust Co.
Old National Bank
North Carolina National Bank
First National Bank of Arizona
National Bank of Commerce
Union Bank
Garfield Ridge Trust & Savings Bank
Essex City Bank and Trust
Merchants National Bank
Palmer-American National Bank
Cleveland Trust Co.
Union Planters National Bank
Trade Bank and Trust Co.
Valley National Bank
Franklin Savings Bank
Chittenden Trust Co.
First National Bank of Passaic
Marshall & Isley Bank
Commercial National Bank

Attachments to Minutes of December 18, 1974

HOLDERS OF PENN CENTRAL COMMERCIAL PAPER AS OF JUNE 21, 1970

1. Archdiocese of Tucson (through Valley Bank)
2. United Conference of Catholic Bishops (through First National Bank of Chicago)
3. Pratt Institute (through Auchincloss & Lawrence and U. S. Trust Co.)
4. Good Hope Corporation (through Auchincloss & Lawrence and U. S. Trust Co.)
5. American Express Company
6. American Automobile Insurance Company
7. Getty Oil Company
8. Olympia Brewing Corporation
9. Welch Foods, Inc.
10. C. R. Anthony Co.
11. Younker Bros.
12. University of Southern California (through United California Bank)
13. L. E. Dixon Co. (through United California Bank)
14. Society for Ruptured and Crippled (through U. S. Trust Co.)
15. Greenwood Mills (through Mfrs. Hanover Bank & Trust Co.)
16. Glen Oaks Club (through Trade Bank)
17. A. C. Monk & Co.

Attachments to Minutes of December 18, 1974

18. Carnegie-Mellon University
19. University of Kentucky
20. Muhlenberg College
21. University-Hill Foundation
    Mallinckrodt Co.
    Niagara Permanent Savings & Loan
    College Life Insurance Company of Indiana
    Homestake Mining Co.
    Granite City Steel
    Norton Simon Corp.
    U. S. Steel Pension Fund
    Marshall & Isley Bank
    Royal Bank of Canada
    Ames Brothers
    Prentice-Hall & Subsidiaries Profit-Sharing Plan
    W. R. Grace & Co.
    Hawaiian Cement
    First Bank of Brownsville, Texas

Exhibit E to Affidavit of Leon T. Kendall sworn to January 23, 1975—Letter from William J. Stephens to Leon T. Kendall, dated December 31, 1974

(Letterhead of)

WILLIAM J. STEPHENS
21 Live Oak Road
Hilton Head Island, South Carolina 29928

December 31, 1974

Re: The Derivative Action
Lasker et al
February 1973

Dear Leon,

At this date I wish to advise that my tentative conclusion is that, in the best overall interest of Fundamental Investors, Inc., this derivative action should not be prosecuted and should therefore be dismissed.

I have given consideration to the following:

#1—Judge Stanley H. Fuld's statement contained in his letter of December 5, 1974 which reads—"As a result of my analysis of the facts and the law, it is my opinion that there was no violation by Anchor or by the Fund directors of any provision of statute or of any common law or contractual obligation to the Fund, in connection with the acquisition and retention of the Penn Central commercial paper."

#2—There is no hard evidence that the adviser did not exercise due care and diligence in the Penn Central transaction. The certain guidelines established for the purchase of commercial paper from dealers are evidence that this transaction was not entered into lightly. It is reasonable to conclude the guidelines were truly a sufficient safeguard.

#3—It is also reasonable for the adviser to place reliance on the presentation and recommendation of Goldman, Sachs & Co., a most astute, prestigious and highly regarded investment banker.

#4—As a purchaser, Anchor was in "first class" company and this conclusion was arrived at by an examination of the "Investor Sales Analysis" from 3/1/68 to 4/2/70, a 12 page document prepared by Goldman, Sachs & Co. Also examined was the list of 73 banks that bought and/or sold Penn Central paper, mostly for the account of customers. It seems evident that the investment community highly regarded the Penn Central commercial paper and purchased it as late as 4/2/70. The statement showed sales of $172,505,000 in this period, not including the $20,000,000 purchased by Anchor. The amount not paid at maturity was $52,205,000 including the $20,000,000 Anchor buy.

#5—Commercial Paper was fully accepted by the investment community. The outstanding commercial paper in the first part of 1970 exceeded $40 billion.

#6—In August 1968 the Interstate Commerce Commission gave Penn Central authority to sell $35 million in commercial paper. On December 17, 1968 the I.C.C. increased the authorization to $100 million. On May 18, 1969 Penn Central announced an increase to $150 million, approved by the I.C.C. On October 29, 1969 the I.C.C. agreed to permit the sale of up to $200 million. At this time the comment on the decision by the I.C.C. to increase to $200 million was, "On the whole, applicant is in a strong financial condition."

#7—Penn Central had a $50 million revolving credit plan. In April 1969, with First National City as the lead bank, the amount of the revolving credit was increased to $300 million. All $300 million was used by the railroad, which eventually defaulted on the loan. There were about ninety banks involved; the majors were First National City $35 million, Irving Trust and Morgan Guaranty $25 million each, Manufacturers Hanover $20 million, with Bankers Trust of New York, Chemical Bank New York Trust, First National Bank of Chicago and Continental Illinois Bank at $15 million each. It is clear the banks did not contemplate that the railroad would be bankrupt within 14 months!

#8—Of more than passing interest is the interlocks of Penn Central directors with the major banks of Penn Central and the railroads indebtedness to these banks as of May 12, 1970.

Director	*Bank*	*Amount*
S. Saunders	Chase Manhattan	$ 7,832,500
	First Pennsylvania	18,004,766
D. Beran	Provident National	57,074,895
P. Gorman	Bankers Trust	26,063,106
J. T. Dorrance, Jr.	Morgan Guaranty	90,972,957
A. E. Perlman ...	Marine Midland	1,083,651
R. S. Rauch, Jr. ..	Girard Trust	49,408,188
R. G. Rincliffe ...	Philadelphia National	12,480,000
	Total	$262,920,063

On June 8, 1970 International Utilities was the largest shareholder of Penn Central with 500,000 shares. They were in the midst of taking a loss of $8 million on their holdings. John Seabrook was Chairman of International Utilities and a Director of Penn Central.

Also it is to be noted that the total railroad indebtedness to First National City was more than $300 million. They were not represented on the Board of Penn Central.

My only comment on this is the observation that the Directors did not know or understand the "soft under belly" of the railroad until it was too late. Question?—If the Directors did not grasp the real financial posture of Penn Central, was it possible for Anchor to reach behind the scenes and get the true picture?

#9—On merger day February 1, 1968 Penn Central had assets of $6.5/7.0 billion. In just 871 days later, on June 21, 1970, bankruptcy proceedings were filed under Section 77. Penn Central was regarded as the backbone of the country's transportation system and had a "Rock of Gibraltar" stature. "Nothing can happen to Penn Central" was accepted in financial centers across the nation. "The banks are behind Penn Central," was regarded as Gospel.

#10—In part, my conclusion that the Lasker derivative action should not be prosecuted stems from my concern about the possible impact on *Anchor and Fundamental Investors, Inc.*

First, as to Anchor:

The amount involved exceeds the total assets of Anchor and, if the award was made, Anchor would cease to be a viable organization. Their ability to attract and retain skilled fund managers would be gone. It would indicate that the Fund Board believed Anchor had violated the law and breached their contractual obligations to the Fund. I do

not so believe. It would be inconsistent to retain Anchor as the Fund adviser and join in a suit against them at the same time. Would the Fund flounder in the interim of changing advisers? I fear so.

Second, as to the Fund:

The impact on the Fund, as a result of public knowledge that the Board had become a plaintiff in prosecuting Anchor would probably result in heavy redemptions. This would compel distress selling of the Portfolio in the current depressed market. As of November 30, 1974, Total Net Assets were $531 million, Short Term investments $21 million, Cash and Receivables $15 million. Net Asset Value per share was $5.13. Recovery of the total amount represents about $.13 a share which is 2½%. The Net Asset Value of the shares, I believe, would be damaged by a far greater percentage if the Board supported the suit. I do not make light of the sum involved but wanted to put it into perspective.

#11—It is my tentative business judgment that the Lasker suit is without merit and that it would not prevail.

Summary

These are my thoughts at this time. I will await answers to some questions that other Directors and I have asked before coming to a final conclusion.

Stephens Letter

Respectfully submitted,

s/ William J. Stephens

wjs/hl

Mr. Leon T. Kendall
7125 N. Barnett Lane
Fox Point
Wisconsin 53217

Mr. Leon T. Kendall
Mortgage Guaranty Ins. Co.
MGIC Plaza
Milwaukee, Wisconsin 53201

Mr. Louis F. Laun
Mrs. Mary S. O'Connor
Dr. Beryl Robichaud

Exhibit F to Affidavit of Leon T. Kendall sworn to January 23, 1975—Minutes of meeting of the Board of Directors of Fundamental Investors, Inc. dated January 6, 1975.

FUNDAMENTAL INVESTORS, INC.

MINUTES OF MEETING OF BOARD OF DIRECTORS
January 6, 1975

A special meeting of the Board of Directors of Fundamental Investors, Inc. was held on January 6, 1975 at the New York Yacht Club, 37 West 44th Street, New York, New York. After discussion commencing at 6:00 p.m., the special meeting convened at 7:30 p.m. There were present:

Leon T. Kendall
Louis F. Laun
Beryl Robichaud
William J. Stephens

constituting a quorum of the Board of Directors. In accordance with the decision reached at the special meeting held December 18, 1974, Mr. Kendall served as Chairman. Also present at the request of the Board of Directors to act as Secretary of the meeting was Eugene P. Souther, Esq., counsel to the Fund.

The special meeting was held to consider further the subjects discussed at the special meeting of December 18, 1974, and to decide what action the Fund should take with respect to the *Lasker* action.

The directors first reviewed and approved the minutes of the December 18, 1974 special meeting. The directors confirmed that none of them had been in contact with anyone affiliated with Anchor Corporation since the December 18, 1974 special meeting.

Mr. Kendall reported to the Board that Mary S. O'Connor was out of the country, but that he had discussed with

her at length the subjects to be convened at the meeting, knew her position on these subjects and had her instructions as to how to cast her vote.

Mr. Kendall reported to the Board that since the December 18, 1974 special meeting he had spoken with each of the other four designated directors concerning the position the Fund should take with respect to the *Lasker* action, and had received from them the additional questions they had on the matter. He reported that he had relayed those questions to special counsel and counsel, and that he had personally spoken with Judge Fuld about the alternatives available to the Fund, and also about the nature and extent of the hearing that might be conducted if the Board of Directors decided to direct counsel to move to dismiss the action.

In response to certain of the questions Mr. Kendall had relayed to counsel from members of the Board, Mr. Souther supplied (1) a detailed biographical sketch of the background and qualifications of Judge Fuld to supplement the information the Board had previously been given, (2) a memorandum outlining the necessary procedures and possible problems which might arise if the Board decided to terminate the advisory agreement between the Fund and Anchor Corporation, and (3) documents with respect to the guidelines now followed by Anchor Corporation concerning short-term investments, including commercial paper. Mr. Souther also reported: that Judge Fuld had never had any prior business connection with Anchor Corporation or anyone affiliated with it; that a computer print-out produced by Goldman, Sachs in the *Welch* action confirmed the identity of other institutional investors that had purchased six to nine month commercial paper of Penn Central; and that the approximate date of the failure of Mill Factors to repurchase commercial paper it had issued was in the spring of 1969.

The Board again reviewed the circumstances of the purchase of the Penn Central commercial paper by the Fund and the repeated and unsuccessful efforts made by the officers of the Fund to have Goldman, Sachs, and thereafter Penn Central, repurchase the commercial paper.

Mr. Kendall reported on his conversation with Judge Fuld covering the probable legal procedures and costs to the Fund directors and shareholders. He also reiterated Judge Fuld's thinking on the various alternatives.

The Board of Directors then discussed each of the three alternatives available. As to the first alternative, *i.e.*, that the Fund seek to realign itself as party plaintiff in the *Lasker* action for the purpose of exercising control over and prosecuting the action, the Board of Directors discussed, among other things, that to do so they would have to (1) determine that they disagreed with Judge Fuld's considered opinion that the directors should not adopt the first alternative because of the lack of merit to the action, (2) conclude that Anchor Corporation and the defendant directors, unaffiliated and affiliated, had violated the law and that Anchor Corporation had breached its contract with the Fund, and (3) decide that the prosecution of the action was in the best interests of the present shareholders of the Fund. The Board expressed its belief that pursuit of the first alternative would necessarily cause the Fund to seek to obtain a different investment adviser immediately, with inevitable serious disruption and damage to the shareholders of the Fund. The Board then considered the potentially disastrous effect on the Fund shareholders such a decision might have and compared it to the remote chance of collecting what would amount at most to between 10¢ and 13¢ per share (prior to counsel fees and expenses) or about 2% of the net asset value of the Fund.

The Board of Directors then agreed unanimously that the Fund should not pursue the first alternative set forth in Judge Fuld's December 5, 1974 memorandum, with Mr. Kendall reporting that Mrs. O'Connor was also against pursuing this alternative.

Concerning the third alternative set forth, *i.e.*, the possibility of taking no position and permitting the action to proceed under the control of the two present plaintiff shareholders, the Board of Directors discussed (1) the distraction and business interruption to Anchor adopting that alternative would present and the possible serious consequences to the shareholders of the Fund that could be expected to follow, (2) Judge Fuld's opinion that Anchor and the defendant directors had not violated the law and were not liable to the Fund, (3) the serious risk of injury to the shareholders from allowing the action to continue weighed against the small percentage per share net recovery which could be expected if there were a judgment in favor of the Fund, and (4) the possibility that the Fund might incur substantial attorneys' fees were the *Lasker* action to continue.

Mr. Kendall and the other directors then discussed in detail Mr. Stephens' letter to him and the other three directors, dated December 31, 1974, in which Mr. Stephens tentatively concluded, on the basis of the 11 detailed considerations he set forth, that the Fund should seek to dismiss the *Lasker* action because of his belief and business judgment that its prosecution was not in the best interests of the shareholders of the Fund. The discussion also covered a broad range of subjects centered on the anticipated effect on the shareholders of the Fund and the Fund if the action were to continue. The directors were concerned, among other things, that there might be immediate and

sizeable redemptions of Fund shares, distraction of the adviser from its duties, loss of employees and inability to attract new ones, loss of interest in the Fund by brokers and dealers, a question as to the continuing ability to sell shares of the Fund and possible eventual loss of the distribution network for shares of the Fund.

Mr. Kendall then reported to the directors on his lengthy discussion with Mrs. O'Connor on December 22, 1974. She had thoroughly reviewed Judge Fuld's memoranda of December 5 and December 18, 1974, Mr. Stephens' letter of December 11, and other material. Mrs. O'Connor had concluded that, for the reasons discussed by the other directors, as set forth above, the Fund should pursue the second alternative in Judge Fuld's December 5 memorandum and should seek to dismiss the *Lasker* action because it is not in the interests of the shareholders or the Fund that the action proceed.

On motion of Mr. Laun, seconded by Dr. Robichaud, the Board of Directors then unanimously adopted the following resolution:

> Resolved, that the law firm of Seward & Kissel, counsel to the Fund, be directed to take the action necessary to have the complaint dismissed in the action in the United States District Court for the Southern District of New York, entitled *Howard M. Lasker, et al.* v. *Harry G. Burks, Jr., et al.*

The Board adjourned at approximately 10:15 p.m.

s/ Eugene P. Souther
Secretary

Supplemental Affidavit of Roger T. Wickers, Sworn to May 4, 1975 in Support of Motion to Dismiss

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
73 Civ. 552 (HFW)

HOWARD M. LASKER, et ano.,

Plaintiffs,

against

HARRY G. BURKS, JR., et al.,

Defendants.

STATE OF NEW YORK
COUNTY OF NEW YORK } ss.:

ROGER T. WICKERS, being duly sworn, deposes and says:

I submit this Supplemental Affidavit to verify certain facts set forth in the Reply Memorandum.

I have read the Reply Memorandum and, to the best of my knowledge all facts stated therein are true and correct. I expressly reaffirm, since it raises new factual matter, the description of the method of selection of the five disinterested directors contained in the second full paragraph on page 13 and the first full paragraph on page 14 of the Reply Memorandum.

I also expressly reaffirm that section 4 of Article VI of the By-Laws of Fundamental is as set forth on page 11 of the Reply Memorandum.

s/ ROGER T. WICKERS

Sworn to before me this
7th day of May 1975.

Excerpts from Defendants' Reply Memorandum

[From p. 11]

Section 4 of ARTICLE VI of the By-Laws of Fundamental provides that:

> "*Quorum:* Except as otherwise provided by law, the Certificate of Incorporation, or these By-Laws, at all meetings of the Board of Directors one-third of the directors then in office, but not less than three directors, shall be necessary for the transaction of business."

* * *

[From pp. 13-14]

Furthermore, plaintiffs erroneously argue that "Anchor controls the selection and nomination of the Fund's board of directors including the so-called independents" (Memorandum in Opposition, p. 41)—this is simply false and uninformed.

The nominees for directorships are searched for and recommended by the Directors' Qualifications Committee, an independent committee of the Board of Directors consisting of two outside directors not affiliated with Anchor and the President of the Funds who is affiliated with Anchor. Majority vote governs recommendation of nominees and, accordingly, it simply is not true, as plaintiffs assert, that "Anchor controls the selection and nomination of the Fund's board of directors including the so-called independents."

Each of the five disinterested directors who made the decision to terminate this litigation was originally selected by the Directors' Qualifications Committee. The five come from widely different backgrounds, and have, in common, excellence in their respective fields of endeavor. None of the five had any prior connection with Anchor.

PAPERS ON RENEWED MOTION TO DISMISS

Affidavit of Roger T. Wickers, Sworn to July 23, 1976 in Support of Renewed Motion to Dismiss

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
73 Civ. 552 (HFW)

HOWARD M. LASKER, et ano.,

Plaintiffs,

against

HARRY G. BURKS, JR., et al.,

Defendants.

STATE OF NEW YORK
COUNTY OF NEW YORK } ss.:

ROGER T. WICKERS, being duly sworn, deposes and says:

1. I am Senior Vice President of Fundamental Investors, Inc. ("Fundamental"), and I submit this affidavit in support of the renewed motion by Fundamental to dismiss this action.

2. Permission of the Court to renew the motion to dismiss was expressly granted in the Memorandum Decision and Order dated September 24, 1975, as amended October 17, 1975, and reported at 404 F. Supp. 1172 (S.D.N.Y. 1975) (Werker, J.). For the convenience of the Court, a copy of the Memorandum Decision and Order is annexed hereto as Exhibit A.*

* To avoid unnecessary repetition, I respectfully seek leave of this Court to incorporate herein by reference the moving papers and reply papers of defendants on the original motion to dismiss. Those papers are part of the file of this action, and, if desired, an additional set will be made available to the Court.

PRIOR PROCEEDINGS

3. Fundamental, joined by all other defendants, moved to dismiss this action on the grounds that it was not in the best interests of the shareholders of Fundamental. The motion was made pursuant to a determination by a quorum of disinterested directors in the exercise of their business judgment, after receiving the advice of independent special counsel. Plaintiffs opposed the motion on numerous grounds. This Court, in the Memorandum Decision and Order, considered and rejected each and every argument advanced by plaintiffs in opposition to the motion by defendants to dismiss.

4. The sole issue that was left open by this Court in the Memorandum Decision and Order is: were the five members of the Board of Directors of Fundamental who made the decision to move to dismiss this action disinterested and independent, or were they, as plaintiffs contend, interested and lacking independence. This Court wrote (404 F. Supp. at p. 1180):

> "If the minority directors were truly disinterested and independent the Court will not substitute its judgment for that of the Board."

5. This Court then permitted plaintiffs "to pursue discovery with respect to the relationships of the minority directors and the Qualification Committee to determine whether the minority directors were disinterested or independent." 404 F. Supp. at p. 1180. The discovery has now been completed and the results are described hereinbelow.

THE DISCOVERY PROCEEDINGS

6. Plaintiffs conducted the depositions of each and every one of the five members of the Disinterested Quorum, as well as the deposition of the Chairman of Anchor Corporation ("Anchor"), the investment adviser to Fundamental. The testimony exceeds 1,000 pages of transcript. In addition, defendants made two major document productions, satisfying all requests made by plaintiffs for production of documents.

7. Despite extensive discovery proceedings, the plaintiffs have failed to turn up any evidence whatsoever that any of the five directors who made the decision for the Board (Messrs. Kendall, Stephens and Laun, Dr. Robichaud and Mrs. O'Connor) was not truly disinterested and independent.

8. Each of the five directors submitted himself or herself to extensive, probing questioning on their business and personal relationships with all of the named defendants. The testimony is abundantly clear that none of these five persons—each a highly distinguished individual in his or her own career—was interested or lacking independence. Each made his or her own decision independently, thoughtfully and with the advice and assistance of eminent special counsel, Stanley H. Fuld, former Chief Judge of the State of New York.

PERTINENT TESTIMONY

10. Dr. Beryl Robichaud, a Senior Vice President of McGraw Hill, Inc., testified that she had no prior business or professional relationship whatsoever with anyone from Anchor or any of the defendants (pp. 120-2);* that no one

* References in parentheses are to pages of the deposition transcripts.

from Anchor attempted to influence her deliberations as a member of the Disinterested Quorum (p. 123); and that she made her decision in this case solely on the basis of what she believed to be in the best interests of the shareholders (pp. 124-5). Copies of the foregoing pages of testimony of Dr. Robichaud are annexed hereto as Exhibit B.

11. Mrs. Mary S. O'Connor, a director and member of the Executive and Trust Committees of the Central Home Trust Company, Elizabeth, New Jersey, and one of the first female officers of IBM, testified that she had no prior business or professional relationship whatsoever with anyone from Anchor or any of the defendants (pp. 83-6); that no one from Anchor or any of the defendants attempted to influence her deliberations as a member of the Disinterested Quorum (p. 86); and that she felt under no pressure whatsoever from anyone at Anchor in connection with making her decision (p. 87). Copies of the foregoing pages of testimony of Mrs. O'Connor are annexed hereto as Exhibit C.

12. Leon T. Kendall, President of Mortgage Guaranty Insurance Corporation, Milwaukee, Wisconsin, testified that he had no prior business or professional relationship whatsoever with anyone from Anchor or any of the defendants (pp. 217-23); that he had never had any economic relationship of any kind with Mr. Haire (p. 224); that Mr. Haire never attempted to influence his deliberations as a member of the Disinterested Quorum (p. 225); and that he felt under no pressure whatsoever from Mr. Haire with respect to his deliberations as a member of the Disinterested Quorum (p. 225). The sole prior connection that Mr. Kendall had with Anchor Corporation was remote and immaterial; Anchor Corporation had been one of approxi-

mately 600 members of a trade association called the Investment Bankers Association which was merged into another association called the Securities Industry Association, of which Mr. Kendall was President (pp. 217-23). Mr. Kendall, in summing up the situation, testified as follows:

> Q. Can you tell us once again, in your own words, the extent of your business relationship or professional relationship, if any, with Mr. Haire prior to the time that you became a director of Fundamental Investors?" A. I had no business, professional, economic, financial relationships with Mr. Haire. The only relationship that existed was in the Trade Association, which I headed, and of which his company was a member." (p. 226, see also 11-22).

Copies of the foregoing pages of testimony of Mr. Kendall are annexed hereto as Exhibit D.

13. William J. Stephens, former Chairman and Chief Executive of Jones and Laughlin Steel Corporation, Pittsburgh, Pennsylvania, testified that he had no prior business or professional relationship whatsoever with anyone from Anchor or any of the defendants, with the immaterial exception that he knew the late Harvey Hopkins, one of the defendants, when they had both been in the steel industry, but that he had had no business relationship with Mr. Hopkins at any time subsequent to 1958 or 1959 (pp. 130-5); that no one from Anchor, nor Mr. Hopkins, nor anyone else had attempted to influence his deliberations as a member of the Disinterested Quorum (p. 135); and that he felt under no pressure whatsoever from anyone at Anchor in his deliberations as a member of the Disinterested Quorum (pp. 136-7). Copies of the foregoing pages of testimony of Mr. Stephens are annexed hereto as Exhibit E.

Affidavit of Wickers in Support of Renewed Motion to Dismiss

14. Louis F. Laun, Deputy Administrator of the Small Business Administration, Washington, D.C., testified that he had no prior business or professional relationship whatsoever with anyone from Anchor or any of the defendants (pp. 148-51); that no one from Anchor had attempted to influence his deliberations as a member of the Disinterested Quorum (p. 152); and that he felt under no pressure whatsoever from anyone at Anchor with respect to his deliberations as a member of the Disinterested Quorum (p. 152). Copies of the foregoing pages of the testimony of Mr. Laun are annexed hereto as Exhibit F.

Conclusion

On the basis of the Memorandum Decision and Opinion of this Court, and on the basis of the discovery proceedings had herein, the renewed motion to dismiss this action should be granted.

s/ Roger T. Wickers

Sworn to before me
this 23rd day of July, 1976.

Affidavit of James C. Sargent Sworn to September 17, 1976 in Opposition to Renewed Motion to Dismiss

UNITED STATES DISTRICT COURT

Southern District of New York

73 Civ. 552 (HFW)

Howard M. Lasker, et ano.,

Plaintiffs,

against

Harry G. Burks, Jr., et al.,

Defendants.

State of New York }
County of New York } ss.:

James C. Sargent, being duly sworn, deposes and says:

1. I make this affidavit at the request of plaintiffs' attorneys in connection with the motion by defendants to dismiss this action.

2. I was admitted to the Bar in the State of New York in 1940 and have been a practicing attorney since that time, except for service with armed forces during World War II and as a member of the Securities and Exchange Commission thereafter. In 1955 I was appointed Regional Administrator of the Commission's New York Regional Office. Shortly thereafter, I was appointed a member of the Commission and served in that capacity from June 29, 1956

until October 21, 1960. I have been a member of the faculty of the University of Virginia Law School and have lectured throughout the country in the fields of proxy contests, securities law and corporate law generally.

3. Traditionally in the mutual fund industry, outside directors, known at various times as "unaffiliated" or "disinterested" directors, have not been independent in any meaningful sense. The absence of real independence has resulted from a variety of causes.

Typically, it is the management of a mutual fund which screens and selects outside directors. Management thereby effectively retains the power to recruit persons friendly to itself to serve as outside directors.

True independence is further negated by the pervasive control exercised by investment advisers over the investment and management functions of mutual funds. This pattern of pervasive control has existed from the very inception of the mutual fund industry and was largely responsible for many of the serious abuses which led to the enactment of the Investment Company Act.

Still another reason for the lack of independence on the part of the outside directors of a mutual fund is management's control of the fund's proxy machinery. Mutual funds are characterized by extreme diffusion of stock ownership. Such diffusion of a company's stock bears a direct relationship to the importance of the proxy machinery in the election of corporate directors—the more widely diffused the stock ownership, the greater the importance of the proxy machinery.

For example, a typical mutual fund has tens of thousands of shareholders. There are few, if any, large blocks of stock. The average shareholder's holdings in the fund are

proportionately insignificant in relation to the fund's total outstanding shares. Management, because of its control of the proxy machinery, has the power to nominate a slate of directors which invariably is elected without opposition. It costs many thousands of dollars to clear proxy material with the SEC and to make mailings to tens of thousands of fund stockholders. To defray such expense, management has at its disposal the corporate treasury. However, for an individual shareholder of a mutual fund, or for a dissident, truly "independent", outside director, a contested election in opposition to management is economically unfeasible and unrealistic since the enormous costs involved would have to be paid out of his or her own pocket. The outside directors' economic investment in the fund, if any, is so slight in relative terms that the cost of filing proxy materials and soliciting shareholders is prohibitive.

Consequently, proxy contests for control of mutual funds are virtually nonexistent. It has been, and remains, a fact in the mutual fund industry that control of the fund's proxy machinery is tantamount to control of the fund itself. The power to nominate directors in a mutual fund is tantamount to the power to elect them. The power to refuse to renominate a sitting director is tantamount to the power to remove him from office.

4. If a quorum of outside directors, comprising a minority of a mutual fund's board, is asked to make a determination on behalf of the fund and that determination might adversely affect the economic interests of the remaining directors, who comprise an absolute majority of the fund's board, and who also thereby control the fund's proxy machinery, the minority directors, in my opinion, cannot be considered truly "independent" in any meaningful sense. Under such circumstances, whether or not the minority

directors attempt to make their determination in good faith, the fact nevertheless remains that the majority directors would have the unchallengeable power to nominate, in connection with the fund's next stockholders' meeting, a slate of directors which would exclude the minority directors and thereby, for all intents and purposes, terminate their directorships.

s/ James C. Sargent

Sworn to before me
this 17th day of September, 1976.

Excerpt from Minutes of Meeting of Board of Directors of Fundamental Investors, Inc. of July 24, 1974

FUNDAMENTAL INVESTORS, INC.

Minutes of Meeting of Board of Directors
July 24, 1974

The regular meeting of the Board of Directors of Fundamental Investors, Inc. was held at the offices of the Fund, Westminster at Parker, Elizabeth, New Jersey, on Wednesday, July 24, 1974, at 1:30 P. M.

There were present:

Edward B. Burr
John R. Haire
S. P. Hutchison
Donald L. Kemmerer
Leon T. Kendall
Louis F. Laun
Thomas A. Martin
Mary S. O'Connor
Charles F. Phillips
Beryl Robichaud
William J. Stephens

constituting the entire Board of Directors.

There were also present Mr. Melvin Intriligator, Executive Vice President—Operations of the Fund; Mr. Roger T. Wickers, Vice President and Secretary of the Fund; Mr. Arthur M. Kesselhaut, Treasurer of the Fund; Mr. James S. Little, Assistant Vice President and Assistant Secretary of the Fund; Douglas B. Steimle, Esq., of Counsel to the Fund; and the following officers of the Investment Division

of Anchor Corporation: Mr. James J. McGonigle, Executive Vice President; Messrs. Ronald L. Welburn, Frank I. Smith, Jonathan P. White, Leonard Brooks, Jr. and Ira Ross, Vice Presidents.

Mr. Edward B. Burr, Chairman of the Board, called the meeting to order and presided, and Mr. Roger T. Wickers, Vice President and Secretary of the Fund, acted as Secretary of the meeting.

* * *

The Secretary referred to the settlement between the Fund and Goldman, Sachs & Co. executed on July 9, 1974, a copy of which had previously been sent to each director, as a result of which the Fund's suit against Goldman, Sachs & Co. was settled and discontinued. He reviewed and discussed the terms of the settlement pursuant to which the Fund sold the notes (which had been purchased by the Fund in 1969 for $18,687,500 and valued by the Board of Directors of the Fund at $2,000,000 since February 24, 1971, to Goldman, Sachs & Co. for $5,250,000 in cash, representing 26.25% of the face value of the notes plus 73.75% of such amount or other consideration, if any, which Goldman, Sachs & Co. or any subsequent assignee may receive upon such notes in the reorganization of the railroad.

The Secretary then discussed the *Lasker* v. *Burks* suit against the Fund, its directors and Anchor Corporation arising out of the Fund's purchase of Penn Central Transportation Company commercial paper, and referred to the motion granted by the Court staying further proceedings in that suit pending the outcome of the Fund's suit against Goldman, Sachs & Co. He stated that because the Fund's suit against Goldman, Sachs & Co. had been settled, the stay granted by the Court in the Lasker action would expire

twenty days following the settlement of the suit against Goldman, Sachs & Co.

The Secretary said that at the time the Board of the Fund determined to commence action against Goldman, Sachs & Co. it reserved whatever rights it might have against Anchor Corporation until the final outcome of the Goldman, Sachs case. He stated that Messrs. Haire, Burr, Hutchison, Phillips and Kemmerer, among others, were named as defendants in the Lasker suit and that Mrs. O'Connor, Miss Robichaud, and Messrs. Kendall, Laun and Stephens, not being directors at the time of the Penn Central transaction, were not named as defendants.

The Board then discussed the matter following which the Board determined that the five directors who are not named as defendants in the Lasker suit and who constitute a quorum of the Board should make the decision, after consulting with independent counsel, as to what further action, if any, the Fund should take.

The Secretary stated that Judge Stanley H. Fuld, former Chief Judge of the Court of Appeals of the State of New York, had indicated his availability to consult with and advise the directors if they so desired. A discussion ensued among the five directors following which the Secretary was instructed to contact Judge Fuld and request that he review all relevant aspects of the Fund's purchase of Penn Central commercial paper, the case against Goldman, Sachs & Co., and the Lasker complaint, with a view towards meeting with the five directors on September 25th, prior to the Board meeting, for a review of his opinion as to what further action, if any, the Fund should pursue.

* * *

Seward & Kissel Memorandum, Dated January 6, 1975

January 6, 1975

Memorandum to Mr. Leon T. Kendall

Mr. Louis F. Laun
Mrs. Mary S. O'Connor
Miss Beryl Robichaud
Mr. William J. Stephens

Fundamental Investors, Inc.

This memorandum is intended to respond to the Board's inquiry by outlining the procedures which would have to be followed and the problems which might arise in case the Board reached the decision to terminate the Agreement (the "Agreement") for Investment Supervisory and Corporate Administrative Services between Fundamental Investors, Inc. (the "Fund") and Anchor Corporation.

1. The Board of Directors of the Fund may terminate the Agreement at any time, without penalty, on 60 days' written notice to Anchor, under the terms of the Agreement and of Section 15(a)(3) of the Investment Company Act of 1940 (the "Act"). Aside from termination, the Board could allow the Agreement to lapse by declining to approve renewal for the annual period commencing May 1, 1975. Even in such event, however, it would be advisable to give Anchor at least 60 days advance notice to avoid a claim of breach of the Agreement by the Fund.

2. If the Board were to exercise its right to terminate the Agreement, it would have to consider whether it should exercise that right with respect to the agreements with the

other six funds in the Anchor Group. The Board might decide to terminate the agreements for some but not all of the funds in the Group, although it would have to be able to offer adequate justification for such a decision.

3. The Board would have to select a new investment adviser willing and able to furnish the Fund with investment supervisory and corporate administrative services for an acceptable fee.

4. If the Board were to serve notice on Anchor of intention to terminate the Agreement before a new investment adviser was selected and agreed to serve, the Fund would have to suspend the offering of shares for sale to the public until the selection was made, since the prospects would be deficient if it did not identify the proposed new investment adviser and describe the new investment advisory agreement. For this reason, notice of termination would in any event not be given until a new adviser had been selected.

5. Following selection of a new adviser, the Board would have to call a meeting of the shareholders of the Fund, prepare and clear proxy materials with the Securities and Exchange Commission and submit the new investment advisory agreement to the shareholders at such meeting. Under the certificate of incorporation of the Fund and Section 15(a) of the Act, the agreement with the new adviser could not become effective until approved by the holders of a majority of the outstanding shares of the Fund.

6. It is possible that some shareholders of the Fund, in disagreement with the Board's decision to terminate the historic relationship with Anchor Corporation, may contest

the selection by the Board and may even nominate their own slate of directors for election at the meeting. It is also possible that a substantial number of shares of the Fund would be redeemed due to, or following the results of, such a proxy contest. The possibility of such a contest might make it more difficult for the Board to find an established investment advisor willing to assume the responsibility.

7. Preparing, filing and mailing proxy statements, holding a stockholders' meeting, amending registration statements with the SEC and all the states where the Fund is registered would impose significant additional expenses on the Fund. Similar expenses would be imposed on the other funds in the Anchor Group if their agreements were also terminated.

8. If the Board were to terminate the agreements with each fund in the Anchor Group, it might find itself in the position of having its choice of a new adviser approved by some of the funds in the Group but rejected by one or more of the others, thus requiring the Board to repeat the process of recommending another adviser until each fund had approved the selection of a new adviser.

9. If the period required for approval of the new adviser exceeded the 60 day notice period under the Agreement or if Anchor ceased to render services during such period, the Board would have to assume full responsibility for administration of the Fund, including portfolio transactions, accounting, legal, regulatory and general corporate matters. The Board would probably have to retain additional employees or one or more service companies to undertake ad-

ministrative services, since Anchor would no longer be furnishing employees for this purpose. The Fund would also have to incur office expenses which are borne by Anchor under the Agreement. During the transition period prior to the shareholders' approval of the new adviser, the Board would not be authorized to retain an investment adviser but would have to rely on employees of the Fund in making portfolio decisions. The lack of a full time, professional investment adviser during this period might, under changing market conditions, result in portfolio losses for the Fund.

s/ Eugene P. Souther

Reply Affidavit of Roger T. Wickers, Sworn to November 9, 1976 in Support of Renewed Motion to Dismiss

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

73 Civ. 552 (HFW)

HOWARD M. LASKER, et ano.,

Plaintiffs,

against

HARRY G. BURKS, JR., et al.,

Defendants.

STATE OF NEW YORK }
COUNTY OF NEW YORK } ss.:

ROGER T. WICKERS, being duly sworn, deposes and says:

I submit this reply affidavit in support of the renewed motion to dismiss and to reply to certain inaccurate allegations made in the papers filed by plaintiffs in opposition to the renewed motion to dismiss.

1. Plaintiffs attempt to make much of the fact that I was the contact with Chief Judge Fuld, and mistakenly assert that I "retained" Chief Judge Fuld. The fact of the matter is, as plaintiffs know from the testimony of all five directors, it was those directors who retained Chief Judge Fuld—I merely performed the mechanical function of contacting him, and determining his availability. Thereafter, I gathered documentary materials and files requested by Chief Judge Fuld, arranged appointments with Anchor personnel requested by Chief Judge Fuld and, at the request

of the five directors, contacted Chief Judge Fuld to coordinate the time and place of his meeting with the five directors. At no time did I ever discuss with Chief Judge Fuld the merits of this action, his report, or any other substantive matter. Since the five directors were from different parts of the country, it would have been logistically inconvenient for them to attempt to perform these administrative functions for themselves.

2. Plaintiffs imply that the Directors Qualifications Committee may have been created for the purpose of finding and nominating directors who would be favorable to the defendants in *Lasker*—nothing could be further from the truth. The facts are these: the Directors Qualifications Committee was established in 1971 in response to shareholder questions on the procedure for selection of directors, and, more specifically, on why there were no female directors. At the time the Directors Qualifications Committee was established, the *Lasker* action, which was filed in 1973, was not even pending. The Directors Qualifications Committee, during the period 1971 through the present, has considered numerous possible candidates, and has sought, at all times, to procure the most highly qualified nominees for membership on the Board of Directors. To complete the record before this Court, annexed to this affidavit as Exhibit A are copies of excerpts of minutes from the meetings of the Board of Directors of Fundamental of July 28 and October 20, 1971, April 25 and July 25, 1973, and the excerpts of the minutes of the meetings of the Directors Qualifications Committee of March 22, 1972, April 25, May 23 and June 27, 1972, relating to the creation of the Directors Qualifications Committee and the nominations of these particular directors.

3. Finally, I respectfully call to the attention of this Court the fact that the Sargent affidavit, submitted by plain-

Reply Affidavit of Wickers in Support of Renewed Motion to Dismiss

tiffs as part of their papers in opposition to the renewed motion to dismiss, is mere personal opinion. Fundamental disagrees with the opinion expressed (i.e., that there is no such thing as a disinterested director of a mutual fund) but, more to the point, Fundamental wishes to record its position that the Sargent affidavit is entirely irrelevant to the sole issue left open by this Court, i.e., whether or not *these* five directors were truly disinterested and independent. Mr. Sargent, to the best of my knowledge, has never met with any of the five directors, nor does his affidavit indicate that he reviewed any of the pleadings, depositions, or other papers in this action. Accordingly, his affidavit should be given no weight on this renewed motion to dismiss.

s/ Roger T. Wickers

Sworn to before me this
9th day of November, 1976.

Appendix A to Reply Memorandum in Support of Renewed Motion to Dismiss—Chart of Relationship of Disinterested Directors and Defendants

Disinterested Director—William J. Stephens

Defendants	*Known to Stephens when he became a director*
Harry G. Burks, Jr.	No
Edward B. Burr	No
Thomas F. Chalker	No
John R. Haire*	No
Harvey C. Hopkins*	Yes
S. P. Hutchison	No
Donald L. Kemmerer*	No
A. S. Mike Monroney	No
Charles F. Phillips	No
Jeptha H. Wade	No
Members of Disinterested Quorum	
Louis F. Laun	No
Mary S. O'Connor	No
Dr. Beryl Robichaud	No
Leon T. Kendall	No

* Asterisk indicates members of the Directors' Qualifications Committee who proposed names to full Board of Directors for nomination as a director.

Chart

DISINTERESTED DIRECTOR—MARY S. O'CONNOR

Defendants	*Known to O'Connor when she became a director*
Harry G. Burks, Jr.*	Yes
Edward B. Burr	No
Thomas F. Chalker	No
John R. Haire*	Yes
Harvey C. Hopkins	No
S. P. Hutchison	No
Donald L. Kemmerer	No
A. S. Mike Monroney	No
Charles F. Phillips*	No
Jeptha H. Wade	No
Members of Disinterested Quorum	
Louis F. Laun	No
Dr. Beryl Robichaud	Yes
William J. Stephens	No
Leon T. Kendall	Yes

* Asterisk indicates members of the Directors' Qualifications Committee who proposed names to full Board of Directors for nomination as a director.

Chart

DISINTERESTED DIRECTOR—LOUIS F. LAUN

Defendants	*Known to Laun when he became a director*
Harry G. Burks, Jr.*	No
Edward B. Burr	No
Thomas F. Chalker	No
John R. Haire*	No
Harvey C. Hopkins	No
S. P. Hutchison	No
Donald L. Kemmerer	No
A. S. Mike Monroney	No
Charles F. Phillips*	Yes
Jeptha H. Wade	No
Members of Disinterested Quorum	
Mary S. O'Connor	No
Dr. Beryl Robichaud	No
William J. Stephens	No
Leon T. Kendall	No

* Asterisk indicates members of the Directors' Qualifications Committee who proposed names to full Board of Directors for nomination as a director.

Chart

DISINTERESTED DIRECTOR—LEON T. KENDALL

Defendants	*Known to Kendall when he became a director*
Harry G. Burks, Jr.	Yes
Edward B. Burr	No
Thomas F. Chalker	No
John R. Haire*	Yes
Harvey C. Hopkins	No
S. P. Hutchison	No
Donald L. Kemmerer*	No
A. S. Mike Monroney	No
Charles F. Phillips	No
Jeptha H. Wade	No
Members of Disinterested Quorum	
Louis F. Laun	No
Mary S. O'Connor	Yes
Dr. Beryl Robichaud*	No
William J. Stephens	No

* Asterisk indicates members of the Directors' Qualifications Committee who proposed names to full Board of Directors for nomination as a director.

Chart

DISINTERESTED DIRECTOR—DR. BERYL ROBICHAUD

Defendants	*Known to Robichaud when she became a director*
Harry G. Burks, Jr.	No
Edward B. Burr	No
Thomas F. Chalker	No
John R. Haire*	No
Harvey C. Hopkins*	No
S. P. Hutchison	No
Donald L. Kemmerer*	No
A. S. Mike Monroney	No
Charles F. Phillips	No
Jeptha H. Wade	No
Members of Disinterested Quorum	
Louis F. Laun	No
Mary S. O'Connor	Yes
Leon T. Kendall	No
William J. Stephens	No

* Asterisk indicates members of the Directors' Qualifications Committee who proposed names to full Board of Directors for nomination as a director.

ORDERS OF COURT OF APPEALS

Orders of Court of Appeals, March 9, 1978, Denying Rehearing and Rehearing in banc

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

Docket No. 77-7060

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the ninth day of March, one thousand nine hundred and seventy-eight.

Present:

HON. J. EDWARD LUMBARD
HON. JAMES L. OAKES
HON. THOMAS J. MESKILL,
Circuit Judges.

HOWARD M. LASKER and IRVING GOLDBERG,

Plaintiffs-Appellants,

v.

HARRY G. BURKS, JR., EDWARD B. BURR, THOMAS F. CHALKER, JOHN R. HAIRE, HARVEY C. HOPKINS, etc.,

Defendants-Appellees.

A petition for a rehearing having been filed herein by counsel for the defendants-appellees.

Upon consideration thereof, it is

Ordered that said petition be and it hereby is DENIED.

s/ A. DANIEL FUSARO,
Clerk

Orders of Court of Appeals, March 9, 1978, Denying Rehearing and Rehearing in Banc

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

Docket No. 77-7060

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the ninth day of March, one thousand nine hundred and seventy-eight.

HOWARD M. LASKER and IRVING GOLDBERG,

Plaintiffs-Appellants,

v.

HARRY G. BURKS, JR., EDWARD B. BURR, THOMAS F. CHALKER, JOHN R. HAIRE, HARVEY C. HOPKINS, etc.,

Defendants-Appellees.

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the defendant-appellees, and no active judge or judge who was a member of the panel having requested that a vote be taken on said suggestion,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is DENIED.

s/ IRVING R. KAUFMAN
Chief Judge